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This paper briefly reviews the history of Chinese banking-system reform since the late 1970s and examines recent government reform efforts in detail, mainly focusing on the reform of state-owned commercial banks, which are handling more than half of the deposits and loans administered by banks in China. It also analyzes the current condition of major commercial banks using a simple international comparison and considers issues and challenges presented by further reforms intended to increase financial stability and provide for the sustainable economic development of China.

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OCCASIONAL
PAPER

Banking System Reform in China

The Challenges of Moving Toward a Market-Oriented Economy

Kumiko Okazaki

RAND NATIONAL SECURITY RESEARCH DIVISION

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Preface

This paper briefly reviews the history of Chinese banking-system reform since the late 1970s and examines recent government reform efforts in detail, mainly focusing on the reform of state-owned commercial banks, which are handling more than half of the deposits and loans administered by banks in China. It also analyzes the current condition of major commercial banks using a simple international comparison and considers issues and challenges presented by further reforms to increase financial stability and provide for the sustainable economic development of China.

The author is an International Visiting Fellow at the RAND Corporation's Center for Asia Pacific Policy, seconded by the Bank of Japan. She benefited from profound and constructive reviews of earlier drafts by Pieter Bottelier, Senior Adjunct Professor of China Studies at Johns Hopkins University; Charles Wolf, Jr., Senior Economic Adviser and Corporate Fellow in International Economics at the RAND Corporation; and William H. Overholt, Director of the Center for Asia Pacific Policy. She is very grateful for their assistance.

She also appreciates the many fruitful discussions she has had regarding China during her study visit with colleagues at the RAND Corporation and the Bank of Japan and with Chinese government officials and scholars. However, the views expressed in this paper are her own and do not necessarily reflect the views of these institutions.

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Abbreviations

ABC	Agricultural Bank of China
ADB	Asian Development Bank
AMC	asset management company
BIS	Bank for International Settlements
BOC	Bank of China
BOCOM	Bank of Communications
BOJ	Bank of Japan
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CDB	China Development Bank
CFETS	China Foreign Exchange Trading System
CIRC	China Insurance Regulatory Commission
CNAPS	China National Advanced Payment System
COMECON	Council for Mutual Economic Assistance
CPC	Communist Party of China
CSRC	China Securities Regulatory Committee
DICJ	Deposit Insurance Corporation of Japan
EIS	Electric Interbank System
FDI	foreign direct investment
FEC	foreign exchange certificate
GATT	General Agreement on Tariffs and Trade
ICBC	Industrial and Commercial Bank of China

GB	government bond
GDP	gross domestic product
IFC	International Finance Corporation
IMF	International Monetary Fund
IPO	initial public offering
JSCB	joint-stock commercial bank
MOF	Ministry of Finance
NPC	National People's Congress
NPL	nonperforming loan
PBC	People's Bank of China
PCBC	People's Construction Bank of China
QFII	Qualified Foreign Institutional Investor
RCC	rural credit cooperatives
ROA	return on assets
ROE	return on equity
SAFE	State Administration of Foreign Exchange
SOCB	state-owned commercial bank
SOE	state-owned enterprise
SSF	Social Security Fund
WTO	World Trade Organization

CHAPTER ONE

Introduction

The reform of the Chinese banking system has progressed favorably since 2002, supported by capital injections, tax exemptions, the introduction of foreign funds, the enhancement of disclosure rules, and other key government policy changes. The major Chinese commercial banks have improved their capital and asset structures remarkably. Four of the five biggest commercial banks have changed their ownership structure and have successfully been listed on stock exchanges. Medium-sized nationwide commercial banks have also developed their business aggressively, although a few of them are still facing serious deterioration in their balance sheets. So far, the Chinese banking system has reduced fears that it will fall into serious disarray in the near future.

Based on confidence about the country's financial stability, the Chinese government opened much of the banking sector to foreign banks in December 2006 (in accordance with its accession commitments to the World Trade Organization [WTO]) by eliminating formerly strict restrictions on foreign banks' local currency business.

However, these changes do not mean that the business foundation of Chinese banks has become completely stable. Compared to the world's leading banks, major Chinese commercial banks are still very weak in terms of asset quality, business profitability, and the diversification of their services. More broadly, the Chinese banking system is not yet functioning as an efficient financial intermediary due to the banks' own weaknesses and to environmental problems such as the loose credit culture and widespread disregard for the rule of law.

These problems are widely acknowledged by senior leaders in China. In January 2007, the State Council (the Cabinet) held a high-level meeting, the Third National Financial Work Conference, to discuss main targets for financial-system reform in the coming years. The government plans to continue to introduce market-oriented mechanisms in the financial sector. Major commercial banks are required to improve corporate governance and to push grass-roots level reforms in local branches. It may prove difficult for them to maintain a balance between "social stability" and commercial profitability if the government and Communist Party do not produce a clear blueprint for the future design of the banking sector.

CHAPTER TWO

A Brief History of Banking-System Reform in China Through the Mid-1990s

The Gradual Implementation of Reform

Currently, the Chinese financial system consists of a variety of institutions, most of which are defined as commercial business entities (with the exception of a few institutions such as policy banks and asset management companies) (see Figure 2.1). While this framework may seem similar to ones in many developed market-oriented economies, two characteristic differences are obvious: (1) the bank loans are heavily weighted toward funding the nonfinancial sectors (see Figure 2.2) and (2) the banking sector is dominated by state-owned commercial banks (SOCBs) and joint-stock commercial banks (JSCBs) (see Figure 2.3).

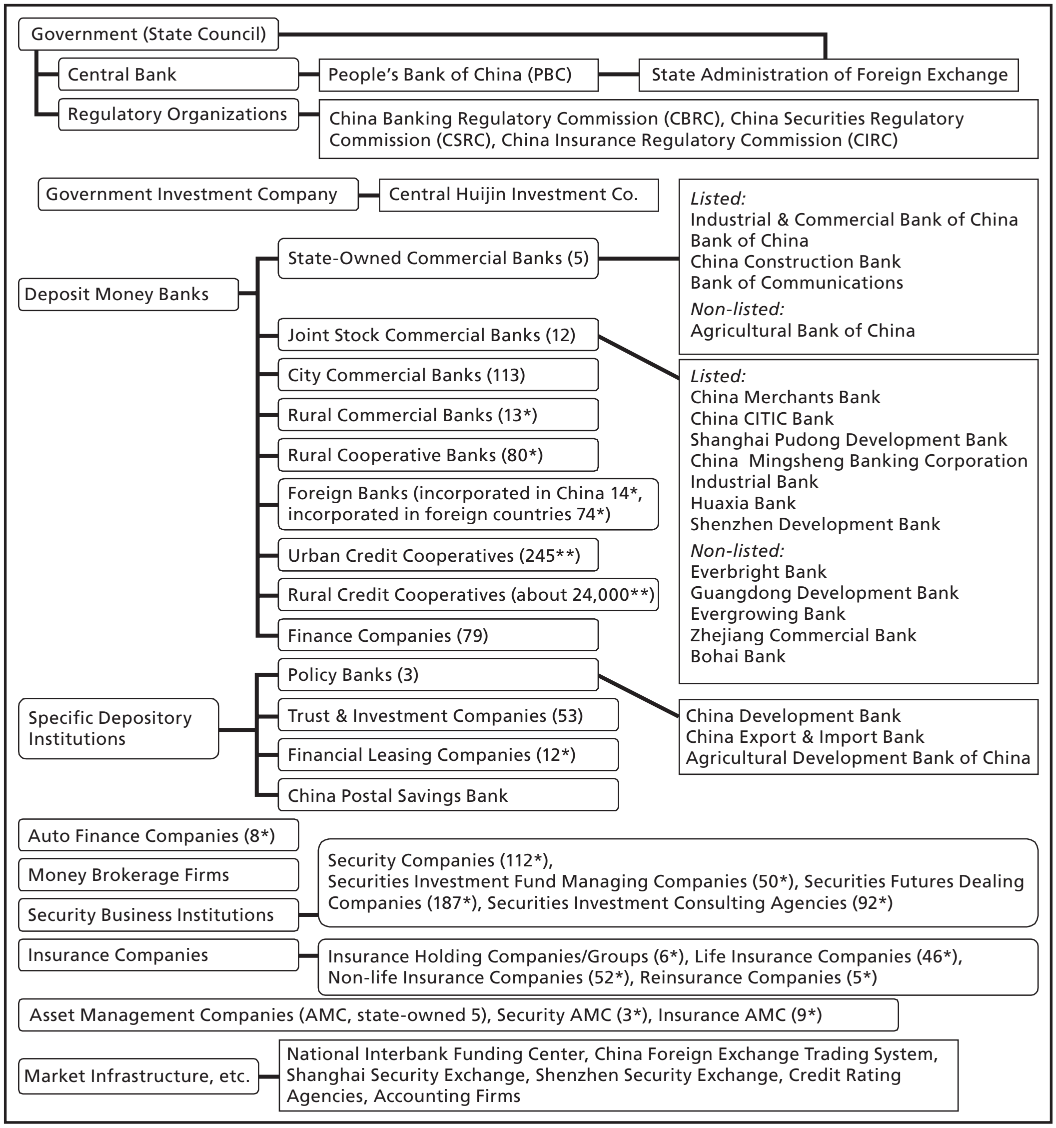
Although there is no standard balance between direct finance and indirect finance, it is widely recognized that an unbalanced financial system often retards the efficiency of fund allocation. In China, the commercial banks had become overburdened, which degraded their balance sheets to the point where they were failing to provide appropriate loans to profitable business sectors with a large potential for growth. This outcome resulted from the government policy on economic-system reform from the late 1970s to the 1990s.

The reforms to the Chinese economic system implemented after the Third Plenum of the Eleventh Central Committee of the Communist Party of China (CPC) in December 1978, which decided to shift the focus of the Party's work to socialist modernization, have been carried out gradually and pragmatically. At first there was no clearly defined goal, and the reform objectives have been cautiously readjusted step by step to move the country from the "planned economy supplemented with some market elements" to the "socialist market economy," gradually becoming more market-oriented, differentiated, and cosmopolitan in accordance with the economic development and social acceptability of the country (see Table 2.1).

During the last 28 years, China has been one of the world's fastest growing economies, with a 9.7–percent average annual increase in real gross domestic product (GDP) from 1978 to 2006. It has become the world's fourth largest economy in terms of the nominal GDP (in U.S. dollars), the third largest trading country, and it was the third largest recipient of foreign direct investment (FDI) in 2005[1]. The gradual nature of China's reform process has ensured

[1] International Monetary Fund, *World Economic Outlook Database*, April 2006, World Trade Organization, *World Trade Report*, 2006, United Nations, *World Investment Report*, 2006.

Figure 2.1
Structure of Financial Institutions in China, May 2007



SOURCES: PBC, CBRC, CSRC, CIRC, China Banking Association, China Trustee Association, China National Association of Finance Companies, Securities Association of China.

NOTES: 1. Figures in parentheses are institutions existing as of the end of May 2007, except those followed by * are as of the end of 2006 and those followed by ** are as of the end of October 2006.

2. In 2007, CBRC made the Bank of Communications an SOCB (from a joint-stock commercial bank).

3. The Agricultural Development Bank of China, a policy bank, is defined as a deposit-money bank when the central bank compiles the monetary statistics.

4. In rural areas, 5 village banks, 3 loan companies, and 6 mutual finance companies were also established.

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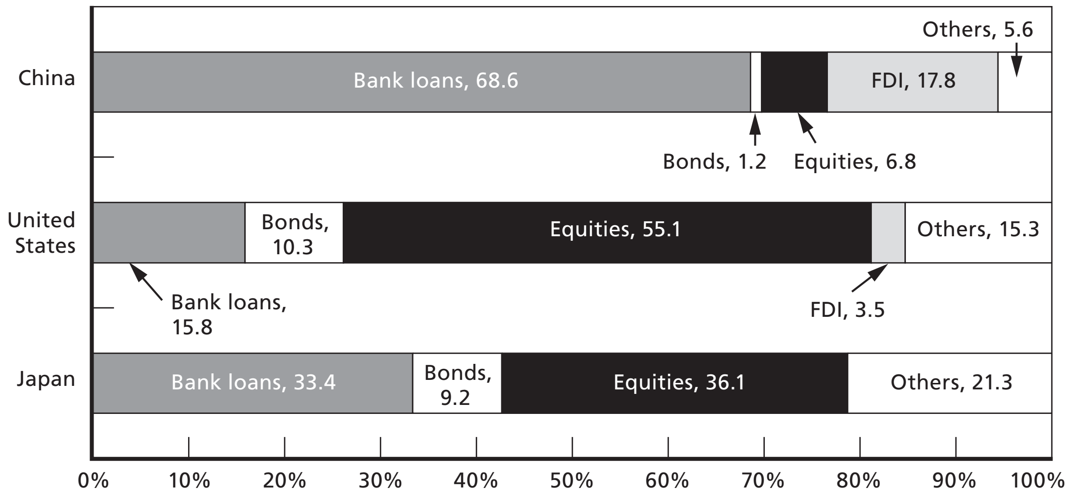
Figure 2.2
Structure of the Nonfinancial Sectors' Liabilities



SOURCES: PBC, Federal Reserve Board, Bank of Japan, *The Flow of Fund Statistics*.
NOTES: 1. Nonfinancial sectors consist of the household sector, the nonfinancial corporate sector, and the government sector.

2. The data for China are on the flow base (average of 2000–2004), while both of those of the United States and Japan are on the stock base (for the United States, as of the end of 2005; for Japan, as of the end of March, 2005).

3. The flow data for China shown here only reflect the liability side and do not include the movement of the nonfinancial sector's deposit. According to the World Bank's analysis, about 50 percent of corporate investment is financed by its own savings, mainly coming from its profit (Kuijs, 2005).

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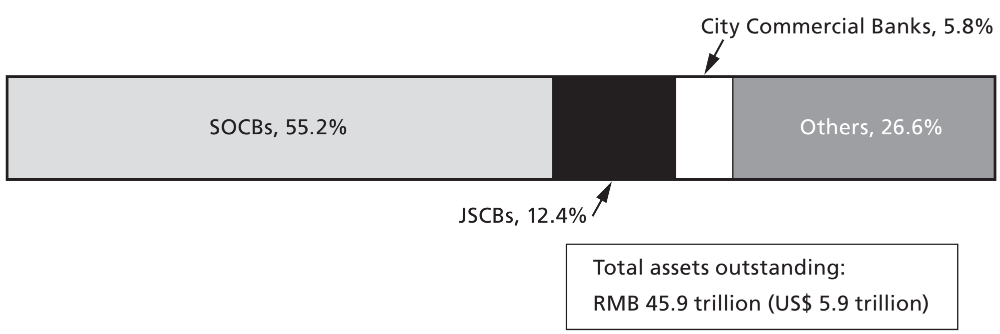
Figure 2.3
Asset Distribution of Deposit-Taking Institutions, March 2007



SOURCE: CBRC.
RAND *OP194-2.3*

Table 2.1
Objectives of the Economic System Reform in China

Time	Key Characterizations of Reform Objectives
1978–Oct. 1984	Planned economy supplmented with some market elements
Oct. 1984–Oct. 1987	Planned commodity economy
Oct. 1987–June 1989	The state controls the market, and the market guides enterprises
June 1989–1991	Organic integration of planned economy and market regulations
1992	A share-holding system and a security market can function under socialism
Oct. 1992	Socialist market economy
1994	Corporatization of state-owned enterprises (SOEs) and reform of property rights
1997	Developing the state sector together with all kinds of ownership Grasping the large SOEs while letting small ones go to the market
July 2001	Three representative functions of the Party; permission for owners of private and individual enterprises to be Party members; further development of various ownership forms

SOURCES: Fan (2002, 2003).

economic stability thus far, despite some volatility in the economy in late 1980s and mid-1990s (see Figure 2.4).

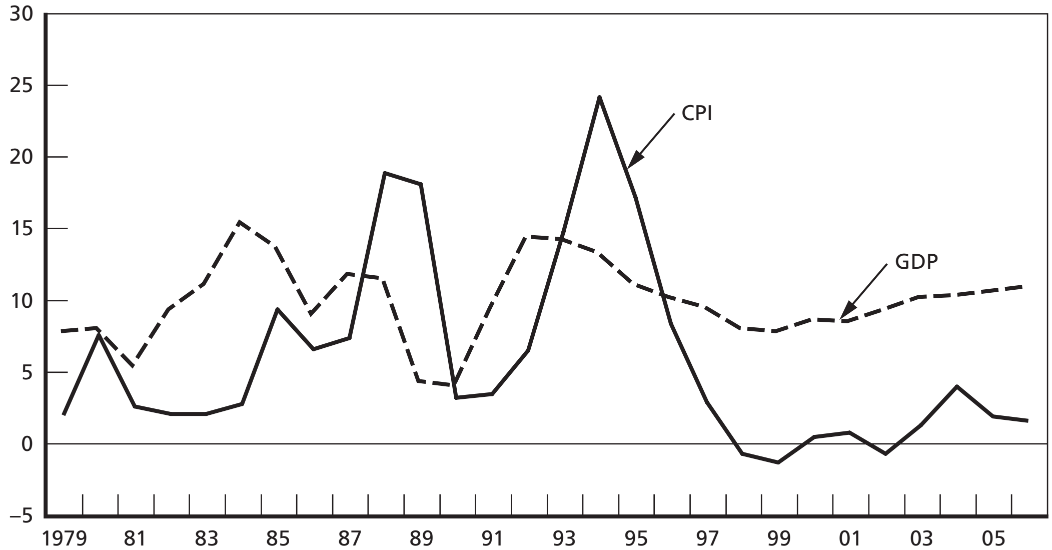
However, the cost of these reforms is not negligible. One of the serious problems with China's economy is the relatively inefficient allocation of funds throughout the financial system, which has been largely dominated by the state-owned banks.

Before 1978, the Chinese banking system was a Soviet-style mono-banking system. During the Cultural Revolution (1966–1976), most Chinese financial institutions were closed or incorporated into the PBC or the Ministry of Finance (MOF); the PBC became virtually the only bank in China. The curtailment of other banks was influenced by denunciations of "bourgeois rights" and by assertions that commercial activity was useless. Loans shrank, and the country's financial business shrank substantially[2]. Even the head office of the PBC was merged with the MOF in 1969; it acted as an accountant and cashier for the government rather than a bank. Beginning in the mid-1970s, the central government tried to strengthen the role of the PBC in order to restore the financial system while keeping it under central control, and in January 1978, the PBC separated from the MOF to function as a bank.

Looking back on the primitive nature of the system at the starting point of the reform effort, the changes in the Chinese banking sector over the past three decades should be regarded as remarkable; however, they have fallen short of creating modern financial institutions that will ensure efficient and sustainable economic growth in China. Banking reforms, as well as reforms to SOEs and government administrations, have been much slower than reforms in other sectors.

[2] Shang, 2000.

Figure 2.4
Changes in the Real GDP Growth and CPI



SOURCE: National Bureau of Statistics of China.
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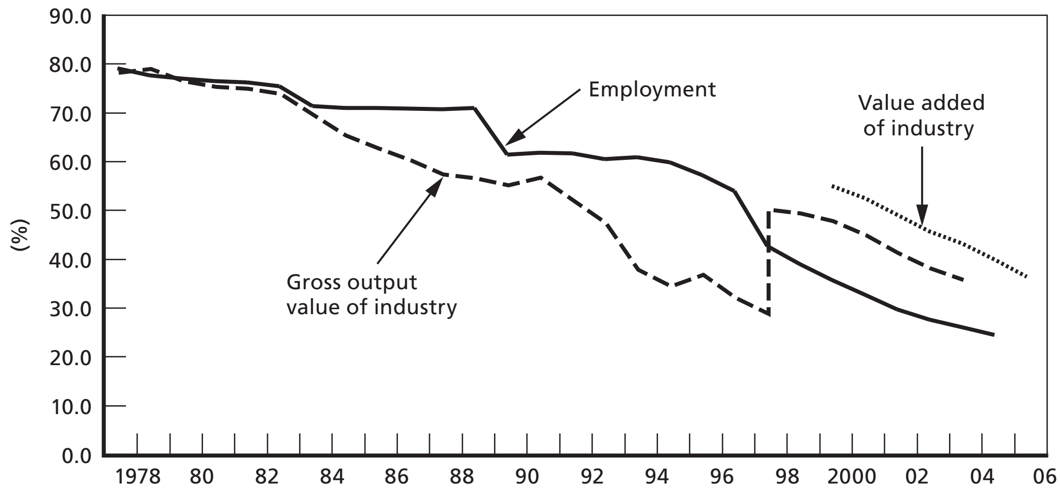
One of the reasons that banking-system reform has been delayed is that the Chinese government, which lost much of its power of fund allocation through the budget, has tried to make up the cost of reforming SOEs through administrative control of the banks[3]. The SOEs have been regarded as a major part of the nation's industrial base for long time; for example, their shares in the industrial production and employment were 60 to 70 percent until the 1980s (see Figure 2.5), and they ran not only business entities but also provided social services such as hospitals, schools, apartments, and public halls for their employees. In order to support the SOEs' smooth and gradual restructuring without causing serious social upset, banks were required to provide SOEs with sufficient capital. In other words, banks were not allowed to prioritize the extension of capital based on profitability or financial efficiency until very recently.

The First Stage of Reform (Establishing Various Kinds of Banks)

The financial-system reform process in China has occurred in three stages (see Figure 2.6). During the first stage (which began in 1978 and continued until 1992), the main goal was changing the mono-banking system into a plural-banking system consisting of a central bank and various kinds of financial institutions.

[3] Wang, 2003.

Figure 2.5
Share of SOEs in Industrial Production and Employment



SOURCE: National Bureau of Statistics of China.
NOTES: 1. "Gross output value of industry" and "Value added industry" is the percentage of state-owned and state-holding industrial enterprises to all industrial enterprises.
2. The data for "Gross output value of industry" is broken in 1998, when the data source was changed from "all industrial enterprises" into "all enterprises with an annual sales income over RMB 5 million."
3. "Employment" is the percentage employees of state-owned entities in an urban area.
RAND *OP194-2.5*

From 1978 until 1984, the four state-owned specialized banks were reestablished or separated from the PBC; each was assigned a special function:[4]

- The Agricultural Bank of China (ABC) undertook financing the rural and agricultural sectors.
- The Bank of China (BOC) undertook financing foreign trade and investment.
- The People's Construction Bank of China (PCBC), which was renamed the China Construction Bank (CCB) in March 1996, undertook financing construction and fixed-asset investment.
- The Industrial and Commercial Bank of China (ICBC) undertook financing the business activities of the SOEs.

These institutions took over the commercial bank business from the PBC. In the mid-1980s, the business-area restrictions on the specialized banks were loosened, and the competitive situation was described as "the BOC is landing, the ABC is entering into cities, the ICBC is going to villages, and the PCBC coming into enterprises."[5]

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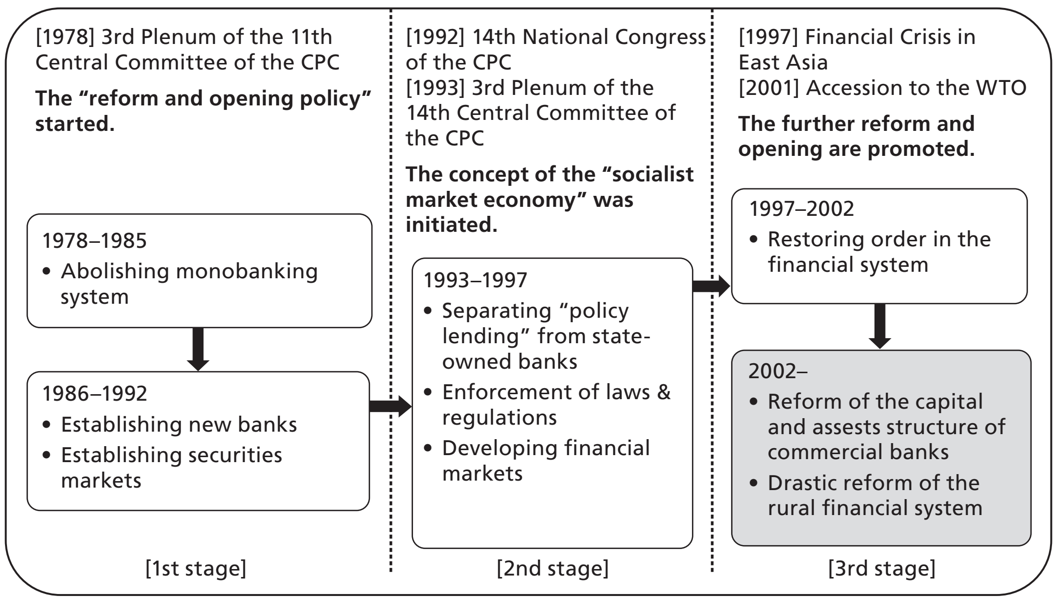
[4] Listed here in the chronological order of their reorganization.

[5] Shang, 2000.

In 1984, the role of the PBC as a central bank was clearly defined: Its mission was to carry out monetary policy, monitor financial markets, issue bank notes, etc. This change basically abolished the commercial bank functions of the PBC. Though the PBC was designated as a central bank, the meaning of this term in regard to the PBC was different than with respect to central banks in market-oriented economies. The PBC was not independent from the government but was a part of the State Council (the Cabinet), and it was required to manage the funding of the SOEs.[6]

In 1986, the Bank of Communications (BOCOM) was reestablished with several types of shareholders; it was later called a JSCB.[7] By the end of 1992, nine JSCBs had been estab-

Figure 2.6
Outline of the Banking-System Reform in China



SOURCES: Shang (2000), Dai (2001), Chen (2002), Wu (2005).
RAND *OP194-2.6*

[6] In September 1983, the State Council decided that the PBC alone should conduct the central bank business beginning in January 1984. However, the Provisional Regulation Relating to Bank Management issued in 1986 stated that the PBC was also responsible for managing the SOEs' demand for operating capital, and the PBC kept providing some kinds of lending services to nonfinancial entities. (Shang, 2000)

[7] The BOCOM was originally founded in 1908. Its domestic business was merged with the PBC and the PCBC in 1958, while its Hong Kong branch continued to operate in Hong Kong as the Bank of Communications. In 1986, the BOCOM was reestablished as a joint-stock bank. Half of the shares in the bank were held by the central government, and the rest were owned by local governments and SOEs (BOCOM Web site; and Lardy, 1998). Under the reform process started in 2002, the BOCOM was often regarded as a SOCB, and in 2007, it is officially defined as an SOCB by the CBRC. The reform process is explained in Chapter Three.

lished. Some of them were conceived of as primarily regional banks but expanded their business areas nationwide within a few years. In addition to these banks, various other financial institutions were established. At the end of 1992, there were 12 insurance companies, 387 trust and investment companies, 87 securities companies, 29 finance companies, 11 leasing companies, 59,000 rural credit cooperatives, and 3,900 urban credit cooperatives in China.[8]

Trust and investment companies were established in order to diversify the fund resources and to provide funds for long-term investments. Some of them were encouraged to raise funds in international capital markets. In the 1980s, both the central and local governments were eager to establish trust and investment companies to promote their construction projects. Rural credit cooperatives were established in the early 1950s. Their ownership structure and responsibilities were not very clear. In the 1960s and 1970s, they were managed by people's communes. When the people's communes were abolished in 1976, the rural credit cooperatives were transformed into the "grass-roots unit" of the ABC, and they were formally separated from the ABC in 1996. A small number of urban credit cooperatives was established in 1979, and the central government formally authorized them in 1986. Their main customers were medium- and small-sized privately owned enterprises and individuals.

In addition, foreign banks were also allowed to establish business entities in China,[9] and by the end of 1992 they had 98 branches/local subsidiaries and 302 representative offices.[10] The foreign banks' business area was strictly restricted until China joined the WTO; this is discussed in further detail in Chapter Three. Until the mid-1990s, their basic function was to introduce foreign funds to support the smooth operation of foreign enterprises in China.

In the mid-1980s, the SOEs' funding source was changed from direct grants by the central or local governments to interest-bearing bank loans and the role of the Chinese banks was transformed from that of government grant distributor to that of creditor.[11] From 1978 to 1992, the total credit balance of Chinese banks increased 11.7 times.[12] Driven by the change in the banks' role and by increases in household income, the funds available in the Chinese financial sector increased rapidly (see Figure 2.7), which in turn provided room for the establishment of some basic financial markets as pilot cases (see Table 2.2).

Although financial markets were firmly established by 1992, the funds for China's economic growth were not allocated through the markets but instead were mostly managed through administrative measures. The main measure by which the central government (includ-

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[8] Shang, 2000.

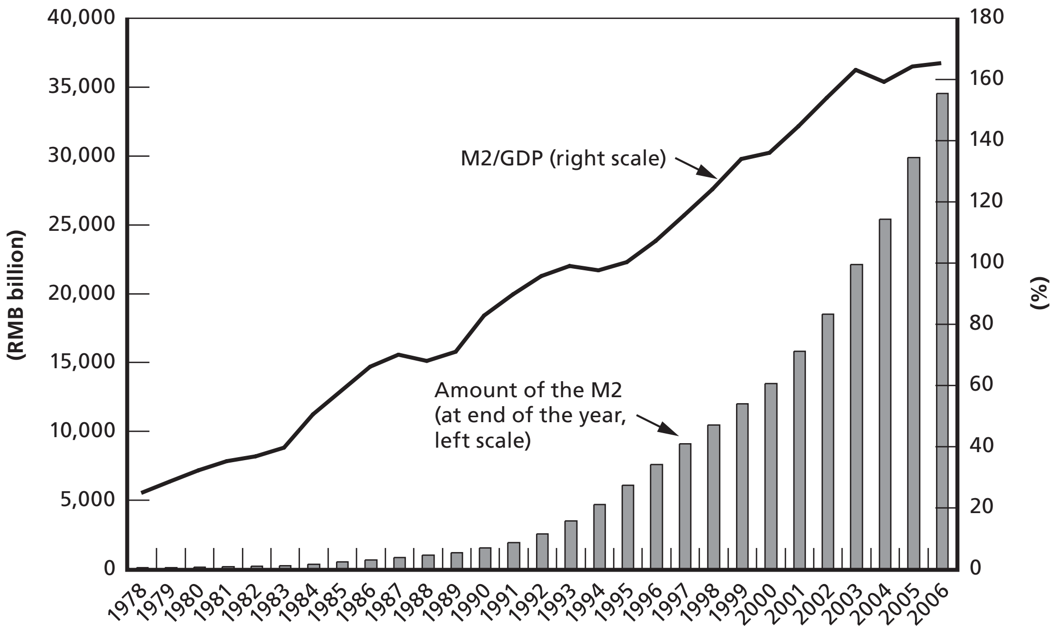
[9] The Export and Import Bank of Japan opened the foreign bank office in China in Beijing in 1979, and the first foreign bank branch was established in Shenzhen in 1981 by the Hong Kong Nangyang Commercial Bank.

[10] Shang, 2000.

[11] In 1981, the SOEs that applied the *duli hesuan* [independent accounting] system were required to use their internal money first and then to borrow money from banks for their *jiben jianshe touzi* [basic capital construction investment]. In 1983, the source of *liudong zijin* [circulating funds] which had been previously provided by the MOF and specialized banks was changed into bank loans only. In 1984, the government decreed that the source of all basic capital construction investment for which the government appropriated budget should be changed from government-direct grants to loans from specialized banks. (Shang, 2000)

[12] Lardy, 1998.

Figure 2.7
The Money Supply (M2 base) and Its Ratio to the GDP



SOURCES: PBC, National Bureau of Statistics.
NOTE: M2 is a measure of the money supply. The PBC's definition of M2 in China is currency in circulation, demand deposits, and quasi-money (time deposits, savings deposits, and other deposits).
RAND *OP194-2.7*

ing the PBC) controlled fund allocation in those days was through the credit plan. The State Planning Commission, working in conjunction with the PBC, imposed an annual credit plan on financial institutions. The commission set the aggregate lending quota for the national economy, which was broken down into a lending quota for each province and municipality with provincial-level administrative status (Beijing, Shanghai, and Tianjin). The PBC provincial-level branches monitored the usage of the quota. Simultaneously, the PBC allocated an annual credit quota to each of the head offices of the major banks, and the head offices divided this amount into lending quotas for the provincial-level branches.[13] Under the credit plan, specialized banks were often forced to provide loans to spur regional economic growth upon local demand without considering the credit risk, and many of those loans often became nonperforming later. On the other hand, this credit-planning system didn't adequately control the total money supply, because the PBC branches were a part of the local governments and were basically expected to contribute, under the direction of local officials, to the economic development of the region and to support the major banks' preferential lending for local construction projects.

During this period, China began to work actively to establish official relationships with some international organizations. China's representation at the World Bank and the International Monetary Fund (IMF) was shifted from Taipei to Beijing in 1980, and since then, both

[13] Lardy, 1998.

Table 2.2
Steps for Establishing Major Financial Markets in China

Market Type	Year	Steps Taken to Develop Markets
Interbank Money Market	1984	Specialized banks are allowed to lend and borrow money from each other.
	1986	PBC officially sets rules for interbank lending.
	1995	PBC establishes local financing centers (*ronzi zhongxin*).
	1996	The National Interbank Funding Center is established in Shanghai, with affiliates in major cities, to unify the interbank lending rates.
Foreign Exchange Market	1980	In addition to the official exchange rate, the internal settlement rate is introduced for the foreign trade units retaining foreign exchange quota. BOC launches the foreign exchange swap business for foreign trade units, and issues Foreign Exchange Certificate (FEC).
	1985	Some branches of the specialized banks other than BOC are permitted to conduct foreign exchange business. Foreign exchange swap centers are established in major cities.
	1994	The official and swap market exchange rates are unified. China Foreign Exchange Trading System is established in Shanghai. FEC is abolished.
	2005	Foreign exchange rate mechanism is reformed.
Government Bond (GB) Market	1981	GB issuance, with a forced allocation method, resumes.
	1988	MOF officially allows GB trade in 61 cities.
	1991	MOF introduces the "syndicated underwriting method."
	1995	GB repo transaction (lending and borrowing with government bonds as collateral upon a repurchase agreement) at the stock exchanges launches.
	1996	MOF introduces auction system for GB issuance.
	1997	PBC prohibits commercial banks from GB repo transactions at the stock exchanges, and allows them to establish the interbank GB repo market.
Corporate Bond Market	1984	The trial of corporate bond issuance starts.
	1985	Some banks and SOEs are officially allowed to issue bonds.
	1993	"Regulation on Corporate Bond Management" is issued, under which the government sets a quota for corporate bond issuance.
	1996	The secondary market for corporate bonds is established.
	2005	Enterprises are allowed to issue short-term notes in the interbank market.
Stock Market	1984	The stock issuance starts.
	1986	Stocks are traded over the counter at some financial institutions.
	1990–1991	Shanghai Security Exchange (1990) and Shenzhen Security Exchange (1991) are officially established. Several local security exchange centers are also built.
	1992	"B share" market is launched.
	2001	Residents are allowed to buy B shares.
	2002	"A share" market is opened to nonresidents through the Qualified Foreign Institutional Investor (QFII) rules.

SOURCES: Shang (2000), Bottelier (2004), He (2005), Kuwata (2006a), Li and Peng (2002), Lu and Zhang (2000), Xie (2002), Zhao (2006), *Chinamoney* Web site.

NOTES: 1. The Chinese phrase *tongye chaijie shichang* is usually translated into English as "interbank money market." However, this market has often been opened to non-bank financial institutions.

2. The "A share" is an RMB-denominated share originally designed to be sold to residents; the "B share" is a foreign-currency denominated share for non-residents.

institutions have provided unique opportunities for China to learn from the experience of other countries in a professional and politically neutral international setting.[14]

Leaders of the CPC gradually recognized the merit of introducing market mechanisms, but cautious thinking was still dominant. In the Eighth Five-Year Plan (1991–1995) that was officially approved in March 1991, the tone was still redolent of the planned economy. The paragraph describing the objectives of financial system reform had clear language supporting the ideas of a planned economy. For example, it stated that "the central bank's leadership and control of specialized banks should be improved" and that "specialized banks should carry out national industrial policy and economic adjustment function."[15] The emergence of ideological arguments about the merits and pitfalls of socialism and capitalism prevented the development of capital markets. Heated arguments arose over the question of whether a market economy can operate within socialism, over the respective roles of economic plans and of markets in resource allocation, and over the question of whether the joint-stock ownership system is an appropriate organizational form in socialism.

The Second Stage of Reform (Implementing Market-Oriented Policies)

Market-oriented policies were widely introduced during the second stage of reform, which ran from 1993 to 1997. After the concept of the "socialist market economy" was formally recognized at the 14th National Congress of the CPC in 1992, the government began large-scale experimentation with financial markets.

Following the announcement of the *Resolution of the CPC Central Committee on Issues Regarding the Establishment of the Socialist Market Economic System* in November 1993, the State Council issued the *Resolution on Financial System Reform* in December 1993, setting the targets of the financial system reform as (1) the establishment of an independent macro economic control mechanism by the PBC (independent from local governments, but under the direction of the State Council), (2) the establishment of policy banks, (3) the transformation of state-owned specialized banks to actual commercial banks, (4) the establishment of unified, open, well-ordered, competitive, and well-managed financial markets, (5) the reform of foreign-exchange control, (6) the issuance of appropriate guidance for the development of non-bank financial institutions, and (7) the development of a financial-service infrastructure and the establishment of a modern financial-management system.[16]

A series of arrangements were made to implement this policy. The government set up three policy banks in 1994 (China Development Bank,[17] the Export and Import Bank of China, and the Agricultural Development Bank of China) to separate policy lending from commercial lending, and the four existing specialized banks became known as "state-owned

[14] Bottelier, 2006a.

[15] Wu, 2005.

[16] Wu, 2005.

[17] At first, the English name of the bank was the State Development Bank.

commercial banks" (SOCBs). The promulgation of the Law of the People's Republic of China on Commercial Banks (also known as the Commercial Bank Law) in 1995 was an effort to enhance the independence of the commercial banks. However, since this law also required commercial banks to conduct business under the guidance of the national industrial policies,[18] the SOCBs had to provide lending to inefficient sectors, such as stagnant SOEs, and they accumulated large volumes of nonperforming loans (NPLs).

In 1995, several other basic laws covering the financial arena were also promulgated: the Law of the People's Republic of China on the People's Bank of China (the Central Bank Law), the Insurance Law of the People's Bank of China, the Law of the People's Republic of China on Negotiable Instruments (the law on bills of exchange, promissory notes, and checks), and the Guarantee Law of the People's Republic of China. Although these measures did not cover the newly developing financial activities completely, they did provide a legal foundation for the rule of law in the financial sector.

The financial markets also developed considerably during this time. In January 1994, the official exchange rate and the swap-market exchange rate were unified. In order to operate unified foreign-exchange transactions smoothly using a computer system, in April 1994 the PBC established the China Foreign Exchange Trading System (CFETS) with a head office in Shanghai and 18 subcenters in major commercial cities to cover foreign-exchange swap centers around the country.

To introduce order into the interbank money market, the PBC established local financing centers in 1995 and closed brokerage institutions run by commercial banks, although the lending rates in the local financing centers still varied greatly. In order to unify these rates, the PBC established the National Interbank Funding Center (which shared its computer system with the CFETS) in Shanghai in 1996 and transformed the local financing centers into the affiliates of the new national center.

The development of the nationwide payment and settlement system enabled the flexible movement of funds among financial institutions. According to the Eighth Five-Year Plan (1991–1995), the PBC was to focus on promoting the computerization of payment systems. In the late 1980s, the PBC began the development of the Electric Interbank System (EIS), which launched in seven cities in 1991 and soon expanded to all areas. The commercial banks were also developing their own intrabank payment systems during this period. Simultaneously, the International Advisory Committee was established by five countries' central banks (Germany, Japan, Switzerland, the UK, and the United States) under an initiative of the World Bank in 1991 in order to develop a the next generation of payment systems. This committee, cooperating with China's Domestic Advisory Committee, advised PBC on system requirements and bidding methods, etc. The new system, the China National Advanced Payment System (CNAPS), has gradually replaced the EIS since 2001. The establishment of the CNAPS, backed by the

[18] Article 34 of the Commercial Bank Law declared that commercial banks shall conduct their lending business in accordance with national economic and social-development needs and under the guidance of the industrial policies of the State; article 41 added that "wholly state-owned commercial banks shall grant loans to projects that need special loans and are approved by the State Council," although this sentence was deleted when the law was amended in December 2003.

loans from the World Bank and the Asian Development Bank, has greatly improved Chinese commercial banks' fund transaction management.[19]

After the concept of the market economy was widely accepted in China, the CPC and government leaders (as well as executives of the SOCBs) were seeking effective ways to commercialize the SOCBs. However, it also became clear that the huge SOE support burden of the SOCBs would be a serious obstacle to reform efforts and therefore should be substantially reduced.

[19] Institute for International Monetary Affairs, 2004, and Keppler, 2005.

CHAPTER THREE

Further Reform for a Market-Oriented Economy

Changes in the Economic Environment Surrounding China

Concerns About the WTO Accession

The negotiations for China's WTO accession, which had been heating up since around 1995, forced Chinese leaders to confront the likelihood of severe competition in the banking sector. This was one of the strongest motivations for them to promote the reconstruction of the fragile Chinese banking sector.

China was an original member of the General Agreement on Tariffs and Trade (GATT), predecessor organization of the WTO, but lost its membership in 1950.[1] After the Reform and Open Policy started, China abandoned its perception of GATT as a "club for rich countries,"[2] joined the meeting of Trade in Textile Committee as an observer in 1981,[3] and formally requested membership in GATT in 1986. While the negotiations around China's entry into GATT initially proceeded smoothly, they stalled for two years after 1989's Tiananmen Square incident and for an additional period during the transition from GATT to the WTO. Once the WTO was established (in January 1995), the Working Party on the Accession of China was formally organized in July 1995 with 74 countries/regions. The group's first meeting was held in March 1996.

The requirements for China's accession to the GATT/WTO were made more stringent during the mid-1990s mainly due to three factors.

First, the breakup of the Soviet Union and the collapse of the Council for Mutual Economic Assistance (COMECON) in 1991 raised the prospect that a large number of transition economies would seek to become GATT members. GATT members therefore made the terms for China's accession relatively rigorous, feeling that they would serve as a template for the accession of these transition economies.

Second, during the 1990s China's expanding foreign trade, increasing inward direct foreign investment, and rapid economic growth altered the perception that many GATT/WTO

[1] The Republic of China participated in GATT in January 1948, and the government moved to Taipei in December 1949. It seceded from GATT in May 1950.

[2] Long Yongtu, Vice Minister of the Ministry of Foreign Trade and Economic Corporation, "*Rushi tanpan shi zheyang wancheng de*" ["How Was the Negotiation for the WTO Accession Completed"], interview, *Caijing*, November 14, 2001.

[3] Japanese Negotiation Team for China's WTO Accession, 2002.

members had of China as a developing country that needed special and differential treatment, and the members put in place more stringent requirements for China's accession.

Third, the transformation from GATT to the WTO made the negotiation targets for the accession wider: After the establishment of the WTO in 1995, China was required to make commitments to not only significantly reduce tariff and nontariff barriers but also to open up long-closed service sectors such as telecommunications, banking, insurance, asset management, and distribution to foreign investors.[4]

The Asian Financial Crisis

The Asian financial crisis of 1997 served to remind Chinese leaders of the importance of the stability of the financial sector. In 2001, the PBC pointed out that the domestic factors that caused the crisis were an unreasonable economic structure, fragile financial systems, inadequate corporate governance, insufficient supervisory framework and risk-control mechanisms in the financial sector, inadequate speed in opening undeveloped capital markets, too much reliance on short-term borrowing from abroad, and a lack of flexibility in foreign exchange-rate management practices.[5] In 1997, analyses of the crisis were not yet very comprehensive, but Chinese leaders were seriously worried about the fragility of the financial sector and about insufficient supervisory systems in China.

Formal Participation in the BIS

China's formal participation in the Bank for International Settlements (BIS) as a member in 1996 provided the PBC with more opportunities to discuss monetary policy and international financial-market conditions with other central banks and to promote cooperation with them in a bank supervisory area.[6] In this context, as well as in its pursuit of fulfillment of the Basel Capital Accord (the international standard of capital adequacy ratios for globally operating commercial banks), the PBC committed to full compliance with the Core Principles for Effective Banking Supervision (the Core Principles) which were released by the Basel Committee on Banking Supervision in 1997.[7] The Core Principles covered such issues surrounding the preconditions for effective banking supervision as licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors, and cross-border banking.[8] These preconditions encouraged the PBC to improve banking supervisory schemes.

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[4] Lardy, 2002.

[5] Dai, 2001.

[6] "*Zhongguo tong Guoji Qingsuan Yinghang Hezuo de Shinian*" ["Ten Years' Cooperation and Development Between China and BIS"], *Jinron Shibao* [Financial News], Aug. 1, 2006. The PBC established a banking business relationship with the BIS in 1984 and seconded a delegation to its annual meeting as observer.

[7] The Basel Committee on Banking Supervision is a committee of banking supervisory authorities established by the central-bank governors of the Group of Ten countries in 1975. It usually meets at the BIS in Basel, where its permanent secretariat is located. At the beginning, the name of the city was spelled as "Basle" in BIS English-language documents, but in later documents, the spelling was changed into "Basel" in accordance with the German spelling.

[8] Press Statement by the Basle Committee on Banking Supervision on Sept. 22, 1997.

First National Financial Work Conference

Against this backdrop, the CPC Central Committee and the State Council held the First National Financial Work Conference in November 1997. The conference decided to promote financial system reform intensively, mainly focusing on the rehabilitation of the four SOCBs, since, as providers of over 70 percent of the country's total loans,[9] they were regarded as too large to fail. More importantly, most of these problems had their roots in the economic system and in past government policies. After the conference, a series of special policy arrangements for the SOCBs were implemented.

Abolishment of the Credit Plan

In order to promote commercial lending by SOCBs, in January 1998, the PBC abolished the credit plan system and required SOCBs to improve the assets and liabilities management practices that were designed in 1994. For the SOCBs, this represented the first step on a path leading to the voluntary management of their fund allocation; the SOCBs gained more rights to independently choose the projects and the enterprises to which they extended loans. However, the central bank still restricted the total amount of credit that the commercial banks could extend and intervened in their lending management, mainly through the so-called window guidance.[10]

The concept of window guidance was imported from Japan, where the Bank of Japan (BOJ, the central bank of Japan) had used it as a tool to control bank lending. Major financial institutions were asked to keep any increase in their lending over a certain period within the level that the BOJ considered appropriate. The BOJ relied especially on the window guidance during Japan's high-growth period (1955–1970), when Japanese financial markets were not well developed, and gradually reduced its use until it was abolished in 1991. The PBC developed window guidance into a management style and has implemented it as one of its major monetary policy tools. Officially, it serves as a kind of moral suasion, imparting guidance on the sectors to which banks should extend credit; however, in practice, it is suspected that it includes lending-volume guidelines.[11]

Capital Injection by the Government

Cleaning up the deteriorated balance sheets of the SOCBs was one of the most important tasks facing reformers, and the government drew up some plans for the SOCBs to increase capital and reduce NPLs. In March 1998, the Standing Committee of the National People's Congress (NPC) passed a plan submitted by the State Council to issue special government bonds to provide for the injection of capital into the SOCBs. The amount of this capital injection was RMB 270 billion (US$ 32.5 billion, equal to 3 percent of China's GDP or 55 percent of the central government's revenues),[12] and the process by which the injection was undertaken was unique,

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[9] Hu, 1999.

[10] Tong and Ding, 2001.

[11] Green, 2005.

[12] The revenue doesn't include the government debt.

since it didn't require any new money. Instead, it changed the structure of the balance sheets of both the government and the SOCBs.

The brief outline of the procedure was as follows:[13]

1. The PBC lowered the legal reserve requirement from 13 percent to 8 percent, freeing up about RMB 377 billion of bank liquidity (roughly RMB 270 billion from the SOCBs and RMB 107 billion from other financial institutions) in March 1998.[14]
2. The SOCBs used the additional liquidity to purchase RMB 270 billion of special bonds issued by the MOF in August 1998.
3. The MOF mobilized the proceeds of the bond issuance to inject capital into the SOCBs.
4. The PBC recalled a part of its loans from the SOCBs to offset the inflationary impact of the reduction in the reserve requirement ratio.

Establishment of AMCs and the Disposal of NPLs

In addition, the government established four asset management companies (AMCs) to take NPLs off the books of the banks. They purchased NPLs amounting to RMB 1.4 trillion (21 percent of the loan balance of the SOCBs at the end of 1998) from the SOCBs and the China Development Bank (CDB) at book value. The government allowed each SOCB to have its own AMC. Organizationally, the AMCs were independent, and their only shareholder was the MOF. However, most of their staff were seconded from the SOCBs, and the AMCs were expected mainly to dispose their original bank's NPLs. The AMCs were originally slated to exist for ten years.

The AMCs were funded by capital injected by the MOF, PBC lending, and their own bond issues. The transfer of the NPLs was accomplished without new money; the AMC bonds were purchased at book value with an equivalent amount of NPLs. When the PBC provided loans to the AMCs, it recalled the same amount of loans from the related SOCBs. On the asset side of ledger, the SOCBs reduced their NPLs by RMB 1,394 billion and increased the AMC bond by RMB 846 billion, and on the liability side of the ledger they reduced borrowing from PBC by 548 billion (see Table 3.1 and Figure 3.1).

When the NPLs were transferred to AMCs, the government introduced the debt-for-equity swap system to keep the SOEs out of bankruptcy. The government chose 580 SOEs and converted their debt claims into AMC-held equity stakes (see Table 3.1). Through the conversion, SOEs would not have to pay interest on the debt, but pay dividends only when they make

[13] Mo, 1999.

[14] Before March 1998, banks in China were required to keep a 13 percent "required reserve" and a 5–7 percent "excess reserve" (the target ratios were different among banks) with their PBC accounts for the purposes of easier fund allocation by the PBC and of securing smooth fund settlement among banks. In March 1998, the PBC unified the two types of reserves and set the reserve requirement ratio at 8 percent as part of a process to improve the efficiency of the PBC's macro economic control mechanisms (Yasui, 2000). However, it was also reported that when the PBC (under the direction by the State Council) decided on the target ratio, they calculated how much liquidity would be needed for the SOCBs to purchase the special government bond that was to be issued in the near future.

Table 3.1
Establishment of Asset Management Companies

	Asset Management Company				
	Huarong	**Great Wall**	**Orient**	**Cinda**	**Totals**
Date established	Oct. 19, 1999	Oct. 18, 1999	Oct. 15, 1999	Apr. 20, 1999	
Related bank(s)	ICBC	ABC	BOC	CCB, CDB	
Total assets at year-end, 2000 (RMB billion)	3,974	2,185	2,893	2,532	11,584
Funding resources through year-end, 2000 (RMB billion)	418	356	277	383	1,434
Capital (RMB billion)	10	10	10	10	40
PBC loans (RMB billion)	95	346	107	0	548
Issuance of bonds (RMB billion)[a]	313	0	160	373	846
Purchase of NPLs through year-end, 2000 (RMB billion)	408	346	267	373[b]	1,394
Amount NPLs in total loan balance (%)	17.9	24.6	20.4	21.7[b]	20.7
Included debt-for-equity swap (RMB billion)	110	12	60	184	366[c]

SOURCES: Nakajima (2003), Wu (2006), Ding (2003), CDB and Cinda AMC.

[a] The bonds issued by the AMCs were purchased by the related banks.

[b] Cinda's purchase of NPLs includes the NPLs purchased from the CDB (RMB 100 billion, including RMB 61 billion debt-for-equity swap).

[c] In addition to the 4 AMCs, CDB itself also concluded the debt-for-equity swap agreement in amount of RMB 40 billion. The total amount of the contract with 580 enterprises was RMB 405 billion at the end of 2000.

Figure 3.1
Changes in Balance Sheets of AMCs, PBC, and SOCBs as to NPL Disposal During 1999–2000

AMCs

Assets (RMB billion)	Liabilities (RMB billion)
NPL +1,394	PBC loans +548
	Bond issuance +846
Total +1,394	+1,394

PBC

Assets (RMB billion)	Liabilities (RMB billion)
Loans to SOCBs –548	
Loans to AMCs +548	
Total 0	0

SOCBs

Assets (RMB billion)	Liabilities (RMB billion)
NPL –1,394	PBC loans –548
AMC bond +846	
Total –548	–548

SOURCES: Nakajima (2003), Wu (2006), Ding (2003).

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a profit. The SOEs were expected to restructure their balance sheets and increase profitability; they were also required to repurchase their equity stakes from the AMCs within ten years.

Along with the transfer of the NPLs, the government required commercial banks to change their loan-classification system from one based on four categories delineated by the status of payment to one based on five categories delineated by a risk assessment, a method widely adopted by more-developed countries. The new loan-classification system was first introduced in major branches of SOCBs and was formally applied to all banks from 2002, in accordance with a guideline issued in December 2001. The previous four-category loan classification system was primarily backward looking (based on the status of payments, such as length of arrearage) and did not reflect the risk of borrowers, while the new system is forward looking and focused on the ability of the borrowers to repay the principal and interest on loan in full and on a timely basis (see Table 3.2). This more-detailed accounting of loans has facilitated reform by making the actual situation of the banks more transparent to regulators and bank managers.

Commercial banks were also required to increase provisions to cover losses from bad loans. Under the old system, as long as they had not matured, loans could still be classified as "performing" even when the enterprise had ceased operation due to financial difficulties; no provisions were required to be made against those loans. In the earlier stage of reform, Chinese banks had only limited discretion in loan provisioning. Starting from 1993, commercial banks were required to make bad loan provisions of 0.6 percent of outstanding loans at the beginning of the corresponding year. Thereafter, the ratio was allowed to rise by 0.1 percent every year until it reached 1.0 percent. Along with the new classification system, the MOF allowed the SOCBs to carry out more-aggressive provisioning against NPLs.[15]

Table 3.2
Definition of Five Categories Under the Guidelines on Risk-Based Loan Classification

Category	Definition
Pass	Borrowers can honor the terms of the contracts, and there is no reason to doubt their ability to repay principal and interest of loans in full and on a timely basis.
Special-mention	Borrowers are still able to service the loans currently, although the repayment of loans might be adversely affected by some factors.
NPLs	
Substandard	Borrowers' ability to service loans is apparently in question; cannot depend on their normal business revenues to pay back the principal and interest of loans; and certain losses might incur even when guarantees are executed.
Doubtful	Borrowers cannot pay back principal and interest of loans in full, and significant losses will incur even when guarantees are executed.
Loss	Principal and interest of loans cannot be recovered or only a small portion can be recovered after taking all possible measures and resorting to necessary legal procedures.

SOURCE: PBC.

[15] Mo, 1999.

However, they didn't have comprehensive guidelines until 2002, when the PBC issued the "Guidance on Provisioning for Loan Losses," which required commercial banks to set aside general reserves and special reserves according to the percentages of the loans outstanding as follows: 1 percent or more for total loans as general reserves, and, as special reserves, 2 percent for "special-mention" loans, 25 percent for "substandard" loans, 50 percent for "doubtful" loans, and 100 percent for "loss" loans.

Improvement of the Accounting System

The accounting system was also gradually changed to improve transparency in the banks' management and operation; these changes also promoted the accurate classification of loans. One of the major changes relating to accounting for bad loans was the revision of the standard for interest accrual on impaired loans. Before 1998, under the accounting system set by the MOF, interest had to accrue to loans whether they were sound or impaired, except when the government agreed to suspend the accrual interest on particular impaired loans. From 1998 to 2001, the MOF stipulated that the interest on loans 180 or more days overdue should cease to accrue on the business accounts of financial institutions.

In January 2002, the MOF implemented a new accounting procedure with a guideline titled "Accounting System for Financial Institutions." Under this system, the number of days overdue after which loans could be classified as accruing interest or not was reduced to 90, the international standard. This meant that interest would not accrue on loans graded "substandard," "doubtful," and "loss."[16] The new accounting system was implemented for listed JSCBs first and expanded to other banks later.

Results of Reform

In spite of the aforementioned effort, the balance sheets of the SOCBs remained poor, with inadequate capital and a large amount of NPLs (see Table 3.3). In fact, the improvements to the accounting practices showed the balance sheet problem of the major banks was much more serious than that had been previously thought.

Liu Mingkang, chairman of the CBRC, which was established in 2003, subsequently explained that government actions in 1998 had been focused on reducing the financial difficulties of banks rather than on overhauling inherent structural problems, and it had became clear that the banks' financial distress had been more deeply rooted than had been previously realized.[17]

WTO Commitments

When China joined the WTO in December 2001, the government made a wide range of commitments regarding the liberalization of its service sectors. It made at least partial commitments

[16] Ye, 2003.

[17] Liu, 2004a.

Table 3.3
NPL Ratios and Capital Adequacy Ratios of the SOCBs (1997–2002)

	ICBC	ABC	BOC	CCB
NPL Ratios				
1997	The average of the 4 banks was more than 25%			
2002	25.41%	36.63%	23.37%	15.17%
Capital Adequacy Ratios				
1997	4.05%	2.93%	3.91%	3.54%
1998	10.40%	8.13%	11.74%	9.31%
1999	4.57%	1.44%	8.50%	3.79%
2000	5.38%		9.80%	6.51%
2001	5.76%	1.44%	8.30%	6.88%
2002	5.54%		8.15%	6.91%

SOURCES: CBRC, Cao (2006), banks' annual reports.

in all service sectors classified by the WTO on *consumption abroad* (mode 2), *commercial presence* (mode 3), and *presence of natural persons* (mode 4) and committed to opening up more than 80 percent of the sectors on *cross-border supply* (mode 1).[18] This situation compared favorably with the average commitments made by other acceding countries, though the number of sectors in which China's government guaranteed full access to the Chinese market was less than the average. A comparison of the coverage of specific commitments to services in trade suggests that China's commitments on market access and national treatment were relatively deep and wide.[19]

China's negotiations with developed countries regarding the Chinese financial sector were intense, since most advanced foreign financial institutions desired flexible access to China's financial markets. The Chinese government tried to protect the country's fragile and immature business sectors, but it also acknowledged the advantages of granting foreign institutions liberal access to the markets, expecting that introduction of foreign experience and international standards would promote reform in inefficient sectors.

As a result, China intended to continue to restrict access to the life-insurance and security markets while committing to fully opening up the banking and non-life insurance mar-

[18] The WTO defines the modes or ways of service supply as follows: Mode 1, *cross-border supply*, is the way that services supplied from one country to another (e.g., an international telephone call or purchase of software or insurance from supplier located abroad). Mode 2, *consumption abroad*, arises when the consumers or firms travel to another country and make use of a service there (e.g., tourism, education, or health services). Mode 3, *commercial presence*, is the way that a foreign company sets up subsidiaries or branches to provide services in another country and involves foreign direct investment. Mode 4, *presence of natural persons*, occurs when individuals travel from their own country to supply services in another (e.g. fashion models or consultants). (World Trade Organization, *Understanding the WTO*, Web site, n.d.)

[19] Mattoo, 2004.

kets within five years after accession (see Table 3.4).[20] Since the banking sector dominated the financial market in China, a majority of leaders in the central government and CPC as well as executives of Chinese financial institutions expected that the opening of that sector to foreign competitors would present both big challenges and big opportunities to the entire Chinese economy.

Moving Toward a Market-Oriented Banking System

Immediately following the WTO accession, the CPC and the Chinese government held the Second National Financial Work Conference (in February 2002) to discuss how to establish a stable, efficient, and competitive financial system while under intense pressure to further open the country's economy. The conference pointed out several serious problems in the financial sector: the incomplete supervisory system, the unsustainable and loose management mechanism of financial institutions, weak mechanisms for protecting the legal rights and interests of financial institutions, a lack of staff with specialized financial knowledge and skills, financial institutions' lack of business innovation, and disorder in parts of the financial market.[21]

The CBRC, a new regulatory organization, was established in accordance with discussions held at the conference and the following several studies by the government and governmental think tanks; it officially began its operation in April 2003. The CBRC was created to fill the need for the specialized regulation of an increasingly complex banking system that was to be fully opened to foreign financial institutions before the end of 2006. Although the PBC had the organizational capacity and human capital to undertake this mission, the central bank had little incentive to do so; the PBC's missions included inflation prevention, growth maintenance, bailing out illiquid financial institutions, and regulating deposit-taking institutions. Among these, the last often took a back seat to inflation prevention and growth promotion.[22]

As to banking-system reform, the conference focused on the rehabilitation of the SOCBs, which accounted for nearly 65 percent of the total assets of deposit-taking institutions at the end of 2001. The government finally acknowledged that the previous unclear ownership system, vulnerability to political pressures, and lack of disclosure had left most of the banks and their interested parties reluctant to reform the old business customs. It proposed to change the SOCBs into JSCBs, which would be listed once conditions had improved.

At the Third Plenary Session of the 16th Central Committee of the CPC in October 2003, Party leaders officially agreed to change the ownership structure of the SOCBs. To pro-

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[20] Mattoo (2004) introduces the indicators for the comparison of China's commitments of market access and national treatment with other countries that were computed by Ianchovichina, Martin, and Wood, which show that China's coverage of market-access commitments (57.4 percent) and the arithmetic-weighted coverage (38.1 percent) were even higher than those of the high-income countries (47.3 percent and 35.9 percent, respectively), and its share of commitments the maximum possible (23.1 percent) was much higher than that of the low- and middle-income countries (7.3 percent) and somewhat lower than that of high-income countries (27.1 percent).

[21] "*Quanguo Jinrong Gongzuo Huiyi Zaijing Zhaokai*" ["The National Financial Work Conference Was Held in Beijing"], *People's Daily*, February 8, 2002.

[22] Shih, 2005b.

Table 3.4
China's Major WTO Commitments in the Financial-Service Sector

Subsector	Commitment
Banking	
Location	Upon accession, foreign currency business is allowed without geographic restriction. Within five years, geographic restrictions on the local currency business of foreign banks will be phased out.
Product	Within two years of accession, foreign banks will be permitted to provide local currency services to Chinese enterprises. Within five years, they will be permitted to provide local currency services to all Chinese customers (enterprises and individuals).
Investment	Within five years, all non-prudential restrictions regarding the ownership, operation, and establishment of foreign banks, as well as those concerning their branches and restriction on issuing licenses, will be eliminated.
Securities	
Product	Foreign securities companies may engage directly in B share business.
Investment	Within three years, foreign investment banks will be permitted to establish joint ventures, with foreign ownership not exceeding 33 percent, to engage in underwriting domestic shares (A shares), and underwriting and trading in foreign currency denominated securities (B and H shares, government and corporate bond).
Fund management	
Investment	Upon accession, the establishment of joint venture fund management companies is permitted, with foreign ownership not exceeding 33 percent. The limit shall be increased to 49 percent within three years.
Life insurance	
Location	Within three years, geographic restriction will be lifted.
Product	Upon accession, foreign life insurers are permitted to provide individual (nongroup) life insurance services. Within two years, they will be permitted to provide health insurance, group insurance, pension insurance, and annuities to customers.
Investment	Upon accession, foreign life insurers are allowed to hold maximum 50 percent ownership in joint ventures.
Non-life insurance	
Location	Within three years, geographic restrictions will be lifted.
Investment	Upon accession, branching or maximum 51 percent foreign ownership in joint ventures is allowed. Within two years, wholly owned subsidiaries will be allowed.

SOURCE: Bahattasali (2004).

mote this reform, a cross-ministries project team, the Central Leading Group on Reforming SOCBs, was established, headed by Vice Premier Huang Ju and managed by PBC Governor Zhou Xiaochuan. The team made plans to reform four SOCBs and BOCOM. BOCOM had been defined as a non-listed JSCB but had also been considered as a kind of SOCB, since the MOF had been a major shareholder (owning about 30 percent of the capital) and the bank

had often been expected to provide loans in the same manner as SOCBs. Under this reform, BOCOM was frequently called an SOCB. In 2007, CBRC officially defined BOCOM as a SOCB in the CBRC's published banking statistics.

Because of the differences in the conditions at these banks, the procedures for their transformations were not entirely uniform; however, a basic idea was shared across the banks: The final goals of the reform were to transform the bank into JSCBs listed on stock exchanges through initial public offerings (IPOs) and to improve their corporate governance and management efficiency. The government adopted four measures to support this restructuring: capital injection, granting the banks approval to issue subordinated bonds to supplement their capital, the disposal of NPLs through AMCs, and permitting the introduction of foreign strategic investors (see Table 3.5). The ABC's problems were regarded as more serious than those of the other four banks and as inextricably related to rural financial-system reform, so its bailout and restructuring program required much more consideration. It is still under discussion as of this writing.

Compared with the government support efforts in 1998 and 1999, this scheme was more comprehensive and transparent, though many questions regarding the details of the accounting process remained. The banks were required not only to change their organizations but also to meet some specific financial targets (see Table 3.6). The government also tried to use market-oriented mechanisms in the disposal of the NPLs and the issuing of the subordinated bond.

Second Capital Injection by the Government

After 2003, the government implemented a unique scheme to inject capital into the system. In December 2003, Central Huijin Investment Company (Huijin) was established, based on the investment of the foreign exchange reserves by State Administration of Foreign Exchange (SAFE).[23] Huijin injected RMB 499.6 billion (US$ 60.4 billion) to four banks as a whole: US$ 45 billion into BOC and CCB in December 2003, RMB 3 billion into BOCOM in June 2004, and US$ 15 billion into ICBC in April 2005. The funding sources for this capital injection were the official foreign exchange reserves (for the U.S. dollar investment) and borrowing (for the Renminbi investment)[24]. Figure 3.2 shows the first example of funds transfer from SAFE to Huijin, and from Huijin to two SOCBs (BOC and CCB) at the end of 2003.

All of the preexisting capital of the BOC and CCB invested by MOF was written off and used for the disposal of their NPLs, which made Huijin a sole shareholder of the banks. However, when Huijin invested in BOCOM, the MOF, the original largest shareholder, increased its investment by RMB 5 billion in order to avoid reducing the value of shareholders' holdings too much, and the Social Security Fund (SSF) also invested RMB 10 billion. As a result, the capital of the bank was mainly shared between MOF (26 percent), SSF (14 percent), and

[23] At the end of 2005, the shareholders of the Huijin are the SAFE, PBC, and MOF (Cheng, 2006). Its original Chinese name is *Zhongyang Huijin Touzi Youxian Zeren Gongsi*, and it is translated into English in different ways in the various SOCB annual reports. For example, the BOC calls it Central SAFE Investments Limited.

[24] The fund resource of the investment into the BOC, CCB, and ICBC was officially described as foreign exchange reserves; however, the fund resource of the investment into the BOCOM was only disclosed as "the style of debt," and it was assumed to have been borrowed from the PBC ("Huijin Gongsi Xu Zhuan Shi" ["Huijin Is Changing from a Virtual Company to Real One"], Renmin Wang Web page, August 10, 2004.).

Table 3.5
Major Arrangements for the Structural Reform of SOCBs Since 2003

Bank		Capital Injection[a]			Issuance of Subordinated Bonds (RMB billion [date])[b]	Disposal of NPLs (RMB billion)[c]	Investment by Foreign Strategic Investors (RMB billion)	Foreign Investors' Share in Capital as of June 30, 2006 (%)	Initial Public Offerings			
	Date of Reogan-ization	Institution	Amount (RMB billion)	Date					Capital Increase (%)	Location	Date	Amount (RMB billion)
ICBC	Oct. 28, 2005	Huijing[d]	124.0	Apr. 2005	35.0 [2005]	705.0	30.5	8.4	44	Hong Kong	Oct. 2006	126.6
										Shanghai	Oct. 2006	46.6
ABC	Plan under discussion.											
BOC	Aug. 26, 2004	Huijing	186.4	Dec. 2003	26.0 [2004] 34.0 [2005]	308.1	43.0	14.1	46	Hong Kong	June 2006	90.0
										Shanghai	July 2006	20.0
CCB	Sept. 17, 2004	Huijing	186.2	Dec. 2003	40.0 [2004]	185.8	32.8	14.4	36	Hong Kong	Oct. 2005	74.6
BOCOM	June 20, 2004	MOF	5.0	June 2004	12.0 [2004]	53.0	14.5	19.9	81	Hong Kong	June 2005	18.0
		Huijing	3.0	June 2004						Shanghai	May 2007	25.2
		Social Security Fund	10.0	June 2004								
Totals			514.6		147.0	1,251.9	120.8					401.0

SOURCES: Bank annual reports; Web sites of the Cinda AMC, Dongfang AMC, PBC, CBRC and MOF; and author's estimates (regarding the disposal of NPLs).

[a] Funding sources: Foreign exchange reserves (RMB 496.6 billion) and other public finds (RMB 18.0 billion)

[b] Issued in the interbank market.

[c] The MOF gave receivables to ICBC (RMB 246.0 billion) and CCB (RMB 65.5 billion) and waived the paid-in capital of BOC (RMB 141.1 billion) and CCB (to a maxiumum of RMB 56.9 billion), for a total of RMB 509.5 billion. The PBC provided AMCs with loans amounting to RMB 619.3 billion to purchase banks' doubtful NPLs. Simultaneously, it sold bills to the four banks in amount of RMB 616.4 billion to offset the impact of the disposal.

[d] MOF also keeps its original invested capital, amounting to RMB 124.0 billion.

Table 3.6
Performance Assessment Indicators for Recapitalized SOCBs

Performance Assessment Indicators	Targets
Return on assets (ROA)	0.6 percent by the second year of restructuring, to be increased to the level of the internationally competitive in three years
Return on equity (ROE)	11 percent by the second year of the restructuring; 13 percent or higher finally
Cost to income ratio	Within the range of 35 to 45 percent after the second year of the restructuring
NPL ratio	5 percent or lower after the restructuring
Capital adequacy ratio	8 percent or higher after the restructuring
Lending share to a single client	No more than 10 percent
NPL provision coverage ratio	60 percent or higher in the year of the restructuring; 100 percent in five years.

SOURCE: CBRC.

Figure 3.2
Changes in Balance Sheets of SAFE, Huijin, and SOCBs (as of the end of 2003)

(Step 1) Establishment of Huijin

SAFE

Assets (RMB billion)		Liabilities (RMB billion)	
Forex reserves (=US$ 45 billion)	–373		
Investment (to Huijin)	+373		
Total	0		0

Huijin

Assets (RMB billion)		Liabilities (RMB billion)	
Forex assets (=US$ 45 billion)	+373	Capital (invested by SAFE)	+373
Total	+373		+373

(Step 2) Capital injection by Huijin to BOC and CCB

Huijin

Assets (RMB billion)		Liabilities (RMB billion)	
Forex assets (=US$ 45 billion)	–373		
Investment (to BOC & CCB)	+373		
Total	0		0

BOC & CCB

Assets (RMB billion)		Liabilities (RMB billion)	
Forex assets (=US$ 45 billion)	+373	Capital (invested by Huijin)	+373
Total	+373		+373

SOURCE: Tsuyuguchi (2007).
RAND *OP194-3.2*

Huijin (8 percent). When Huijin invested capital in ICBC, the MOF did not write off all of the preexisting capital but kept the same level of investment as that of Huijin. Presumably, the MOF had balked at the prospect of the PBC, which was the administrator of the SAFE, gaining control over major state-owned banks through Huijin and had tried to retain control over 50 percent of ICBC shares.[25]

The resulting capital injection (from 1998 to 2005, RMB 785 billion or US$ 95 billion: RMB 270 billion in 1998 and RMB 515 billion from 2003 to 2005) was equivalent to 10 percent of the central government's revenue for the period 1998–2005 (excluding debt income). The scale of the capital injection can be compared with the Japanese government's injection of capital into commercial banks from 1998 to 2003 through the Deposit Insurance Corporation of Japan (DICJ), which amounted to JPY 12.4 trillion (US$ 116 billion), about 4 percent of 6 years' of the government's general budget income (excluding debt income).

The Japanese government believed that its role as a shareholder should be temporary: It didn't directly inject capital to commercial banks but supported the DICJ (the government held 33 percent share of its capital) to effect the capital injection. When the DICJ injected capital, the funds raised (issuing bonds or borrowing from banks) were guaranteed by the government, which meant the government committed to cover most of the losses to the DICJ if the banks were to fail. The Japanese commercial banks had an incentive to repay the injected funds as early as possible, since a commercial bank's reputation in the market would not be very high when it was regarded as being under government control. Through November 2006, about 66 percent of the injected funds had been repaid to the DICJ, which included 100 percent repayment by the biggest three commercial banks.

The Chinese government, on the other hand, did not intend to change the SOCBs into private banks and so conceived a bailout plan whereby the government would maintain majority ownership. Furthermore, it looked for an effective way to exercise its rights as a shareholder. Since the state lacked an actual shareholder presence in SOCBs and SOEs, it encouraged the mistaken belief among the managers of those banks and enterprises that they represented the state. When a conflict occurred between the interests of SOCBs and the SOEs, it was relatively easier for SOEs to ally with the leaders of local governments and CPC affiliates to justify their actions as a means of maintaining employment levels to ensure social stability.[26] Even within the central government there was no strong consensus to protect SOCBs' commercial interests. After they were transformed into commercial banks, the SOCBs still suffered major losses due to government policy: From 1995 to 2002, they had supported the restructuring of more than six thousand SOEs, provided RMB 800 billion of policy loans, and suffered RMB 316 billion of lending losses.[27] By the end of 2002, 51.2 percent of the 62,000 firms that had completed the change of ownership had failed to repay bank loans.[28]

[25] Shih, 2005a.

[26] Cheng, 2006.

[27] "Xie Ping: Huijin Bu Jieru Gufenzhi Yinhang," 2005.

[28] Luo, 2003.

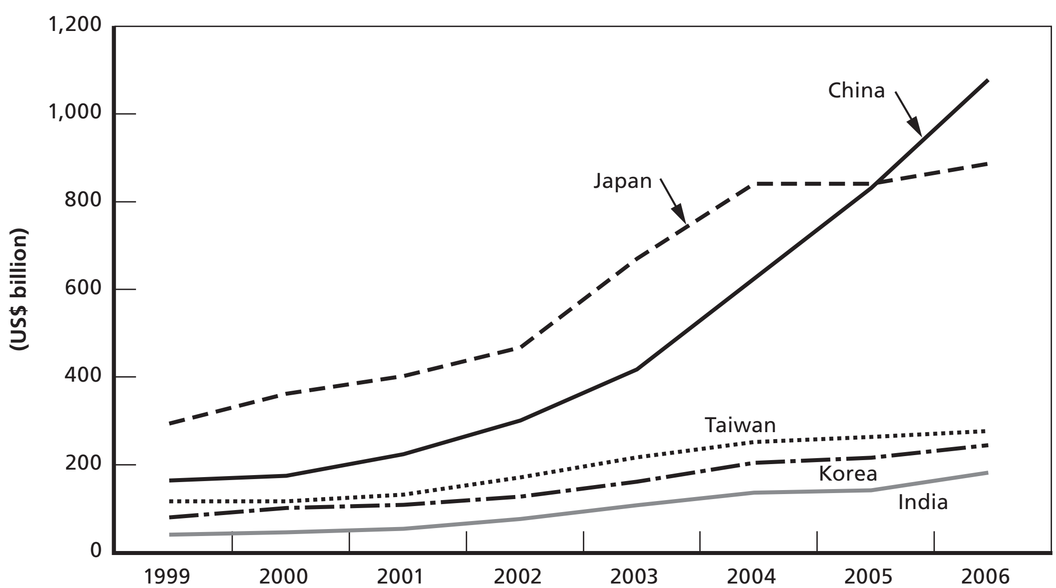
In this uncertain and unstable environment, Huijin was expected to become an influential shareholder of SOCBs and to urge them to carry out their reform plans, to improve their corporate governance, and to gain efficient returns from their business. Many of Huijin's key personnel came from the PBC Financial Stability Bureau, including the president, Xie Ping, the former director-general of the bureau.

Another unique aspect of the capital-injection effort was the use of the official foreign exchange reserves. In addition to their desire to avoid possible deterioration of the government's balance sheets, Chinese leaders were also looking for an efficient way to use the rapidly increasing foreign exchange reserves. The foreign exchange reserves of China more than doubled from 2001 to 2003 and have continued to expand enormously, reflecting China's expanding trade surplus and the large influx of short-term speculative capital as well as foreign direct investments under the de facto pegged exchange rate system (see Figure 3.3). Under these circumstances, demand increased for more-efficient and profitable foreign-exchange-reserves management, and the government began a trial with a specific investment company. Huijin President Xie Ping explained that the capital injected by his organization into SOCBs could expect higher return than the typical return on the general investment of the foreign exchange reserves.

Disposal of NPLs Using Market Mechanisms

As a part of the preparation for IPOs, BOCOM, CCB, BOC, and ICBC were again (and in the case of BOCOM, for the first time) allowed to transfer their NPLs to AMCs. These transfers totaled more than RMB 1,200 billion, which was about 80 percent of their reported

Figure 3.3
Trend of Official Foreign Exchange Reserves in Asia



SOURCE: International Monetary Fund, *International Financial Statistics*, database.
RAND *OP194-3.3*

NPLs and 18 percent of the loan balance at the end of 2002 (excluding ABC), some at face value, and some at discounted prices (see Tables 3.7 and 3.8). The government allowed four banks to transfer most of their NPLs that fell in the "loss" and "doubtful" categories (before the reorganization) into AMCs: The total amount of "doubtful" NPLs held by the four banks at the end of 2002 was RMB 814 billion, and they transferred RMB 778 billion of them into AMCs. The amount of "loss" category NPLs of BOC, CCB, and BOCOM at the end of 2002, and of ICBC at the end of 2004, was RMB 633 billion, and they transferred RMB 456 billion of them into AMCs.

To promote the disposal of the NPLs, the MOF provided more than RMB 500 billion by releasing its original paid-in capital (paid in to ICBC, BOC, and CCB) and making up the resulting loss with a form of receivable (to ICBC and CCB, which was to be offset mainly against the future profits and dividends of the banks). The PBC provided the AMCs with loans of about RMB 620 billion for the purchase of the doubtful NPLs. The PBC's loans had little direct impact on the country's money supply, since the PBC required four banks to purchase a nearly equivalent amount of PBC's special bills (RMB 588 million) using the proceeds paid by the AMCs. From the commercial banks' point of view, it was as if their doubtful loans were changed into special bills issued by the PBC.

Since these forms of support were based on the government's recognition that most of the NPLs were caused by unreasonable national economic and industrial policies of the past and on the premise that financial stability would be crucial for the further economic development, the central government intended to assume the final cost for the disposal. However, the government also required commercial banks to share in the losses as much as possible and tried to introduce market mechanisms in a step-by-step manner.

When the doubtful loans were sold to AMCs, the government introduced auction systems and cut the direct relationship between the SOCBs and AMCs. For example, Cinda AMC, which was linked to CCB, purchased the doubtful NPLs of BOC, CCB, and BOCOM through an auction in the primary market, and later, it sold the doubtful loans of CCB to Orient AMC, which was linked to BOC. At the auction of ICBC's doubtful loans, Great Wall AMC, which was linked to ABC, purchased more than 56 percent of them. There were some rumors that the auctions were not completely managed under market mechanisms; however, selling NPLs to non-relating AMCs represented a major change, on that made it easier for AMCs to sell NPLs at more market-based values in the secondary market.

The selling prices were still relatively high. The doubtful NPLs of BOC, CCB, and BOCOM were transferred to Cinda AMC at a 50 percent discounted price, and the ICBC's doubtful NPLs were transferred at book value. There was little information on the procedure by which the difference between the auction price (31 percent of the book value for the BOC, CCB, and BOCOM's NPLs, and 26 percent for ICBC's NPLs)[29] and the transferred price was accounted for. The PBC provided AMCs with an amount of loans equal to transferred NPLs at book value, PBC therefore incurred a risk that the AMCs would fail to repay the loans if the MOF doesn't make up the loss though the disposal of NPLs.

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[29] "Gonghang Caiwu Chongzu Luomo," 2006.

Table 3.7
SOCBs' Disposal of NPLs

	Disposed NPLs			
Institution	Loan Category	Amount (RMB billion)	Date of Action	Processes and Funding Sources
ICBC	Loss	246.0	June 2005	The bank transferred the loss NPLs to Huarong AMC at book value. The MOF covered the cost while giving receivables to the bank. The receivables were to be offset mainly against the bank's future profits and dividends to MOF.
	Doubtful	459.0	June 2005	The bank sold the doubtful NPLs to 4 AMCs through auction, receiving book value.[a] The PBC provided the AMCs with loans to purchase the NPLs. The bank purchased PBC special bills (RMB 430.5 billion) and repaid a part of PBC loans (RMB 28.4 billion).
BOC	Loss	141.4	Sept. 2004	The bank wrote off the loss NPLs and transferred them to Orient AMC. The cost of the disposal was made up with the original paid-in capital held by MOF and from the capital reserve and surplus reserve of the bank.
	Doubtful	148.6	June 2004	The bank sold the doubtful NPLs to Cinda AMC at 50% discounted price. The PBC provided Cinda AMC with loans to purchase the NPLs. The bank purchased PBC special bills (RMB 73.4 billion). The loss accrued through the disposal was mainly offset against the bank's reserves.
	Other	18.1	June 2004	The bank exchanged a part of old policy loans with PBC special bills.
CCB	Loss	56.9	Dec. 2003	The bank wrote off the loss NPLs and transferred them to Cinda AMC. The cost of the disposal was made up by the original paid-in capital held by MOF and from the capital reserve and surplus reserve of the bank.
	Doubtful	128.9	June 2004	The bank sold the doubtful NPLs to Cinda AMC at 50% discounted price.[b] The PBC provided Cinda AMC with loans to purchase the NPLs. The bank purchased PBC special bills (RMB 63.4 billion). The loss (RMB 65.5 billion) accrued through the disposal was made up with receivables from the government, which should be offset against the bank's future profits.
BOCOM	Loss	11.6	June 2004	The bank wrote off the loss NPLs and transferred them to Cinda at face value and sold the doubtful NPLs to Cinda at 50% discounted price. The PBC provided Cinda with loans to purchase the doubtful NPLs. The bank purchased PBC special bills (RMB 20.7 billion). More than a half of the loss by the disposal was offset with the bank's reserve, and the remaining loss was to be offset against the bank's future profits.
	Doubtful	41.4	June 2004	
Total		1,251.9		Loss=455.9, Doubtful=777.9, Others=18.1 (all in RMB billion)

SOURCES: Annual report and prospectus for the Hong Kong IPO of each bank, PBC Monetary Policy Report, Web sites of Cinda AMC and Huarong AMC.

[a] The ICBC claims that the doubtful NPLs were disposed at book value, although some journals report that the average selling price through the auction was 26.4% of book value and that the loss was made up by the PBC.

[b] The Cinda AMC sold the doubtful loans of the CCB to the Orient AMC in November 2004.

Table 3.8
Funding of SOCBs' Disposal of NPLs

Instituition	Amount (RMB billion)		Mechanism
MOF	509.5		
		311.5	By providing receivables to ICBC and CCB
		198.0	By releasing paid-in capital for BOC and CCB
PBC	619.3 to AMCs		
		458.8	By providing loans for ICBC
		160.5	By providing loans for BOC, CCB, and BOCOM
	(616.4) from banks		
		(28.4)	PBC recalled lending from ICBC
		(588.0)	PBC sold bills to the four banks

SOURCES: Annual report and prospectus for the Hong Kong IPO of each bank, PBC Monetary Policy Report, Web sites of Cinda AMC and Huarong AMC.

Introduction of Foreign Strategic Investors

The introduction of foreign strategic investors was one of the most drastic policy changes in China. For a long time, the government had been very cautious about allowing foreign investors to buy shares of domestic banks. Acknowledging the positive effects of foreign direct investment in other sectors, they finally decided to widely allow foreign capital into the banking sector. In December 2003, the CBRC issued a rule regarding foreign equity investment in Chinese financial institutions, and it raised the limit on equity shares held by a foreign investor in a Chinese financial institution to 20 percent from the previous 15 percent. Moreover, the rule stipulated that "where the combined equity investment proportion of all overseas financial institutions in a non-listed Chinese financial institution is equal to or exceeds 25 percent, the non-listed Chinese financial institution shall be treated as a foreign funded financial institution by the regulatory authority."[30] Under this article, the combined limit of the foreign investors' shares in any bank is understood to be 25 percent.

The government has been encouraging Chinese banks to make deals with foreign financial institutions in accordance with each institution's plans for structural reform. The word *strategic* implies that the government does not seek only to introduce capital. The foreign strategic investors are expected to bring new long-term capital, to transfer new management systems and techniques, and to improve the corporate governance of the commercial banks.

Foreign financial institutions have also been interested in joining Chinese banks, expecting that these investments will bring favorable opportunities for business expansion without the risks and hassles of establishing their own local affiliates, acquiring a deep understanding

[30] CBRC, 2003.

of Chinese business customs, and preparing for new businesses in the wide-open financial markets possible in the future. At the same time, there are also many international banks that have strong reservations about participating in Chinese banks as small, minority investors.[31] According to the CBRC, through the end of 2006, about 30 foreign financial institutions had purchased stakes in 21 Chinese commercial banks through strategic-investment agreements. The total investment amounted to US$ 19 billion; the arithmetic average of the total capital per Chinese bank was about 16 percent (see Table 3.9).

Tax Exemptions

In addition to these arrangements, the MOF allowed tax exemptions related to the write-offs of NPLs and the organizational restructuring. For instance, the CCB officially announced that its income tax exemption was RMB 15.4 billion in 2004 and RMB 7.4 billion in 2005. The bank's ROA was reported as 1.31 percent in 2004 and 1.11 percent in 2005, but it also disclosed the ROA without the tax exemption at 0.90 percent and 0.92 percent for 2004 and 2005, respectively.

Organizational Restructuring

Since 1998, SOCBs has been required to improve organizational management efficiency by reducing the number of branches and employees. The number of operational networks has been reduced by nearly 50 percent, and the number of employees has been reduced by 20 percent across the board (see Figure 3.4). Some banks reduced long-term contract employees and increased short-term ones. These arrangements should have contributed to increase banks' profitability.

Public Listing

The final step in the reform of the ownership structure is the public listing of bank securities. From June 2005 to May 2007, BOCOM, CCB, BOC, and ICBC undertook successful IPOs and were listed on stock exchanges. At first, the government preferred to use overseas markets because they recognized that market pressures, including requirements for qualification and disclosure, would be much stronger there than in domestic markets and that the foreign markets would force the banks' strict adherence to the structural reform effort. The fact that the domestic stock markets had been sluggish for the four years after 2001 (see Figure 3.5) was also a consideration. Thus, the first two IPOs (for BOCOM and CCB) were carried out in Hong Kong. However, responding to the criticism that only listing bank securities abroad limited domestic investors' opportunities to invest in the country's largest national banks, the government decided to list BOC and ICBC in both Hong Kong and Shanghai. In May 2007, BOCOM carried out the additional IPO in Shanghai.

The IPOs were welcomed by the markets, (selling prices were about 2.4 to 3.1 times of the face values at the IPOs since 2004 to 2006, and 7.9 times at the BOCOM's IPO in 2007). As a result, the capital of the four banks increased 30 to 80 percent (see Tables 3.10 and 3.11).

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[31] Organization for Economic Co-operation and Development, 2005.

The IPOs force a large change in the ownership structure, though state ownership is still highly dominant (see Table 3.12).

One favorable effect of the IPOs was the improvement of disclosure. The four banks invited foreign accounting offices to review their balance sheets, profit and loss accounts, and cash flow statements. Currently, not only SOCBs but also most of JSCBs ask foreign accounting offices to review their financial reports, and they disclose the results much faster and much clearer than before.

Table 3.9
Examples of Direct Investment in Chinese Banks by Foreign Strategic Investors

Chinese Banks	Foreign Strategic Investors	Nationality	Date of Agreement	Deal Size (US$ million)	Share in Capital (%)
State-owned commercial banks					
ICBC	Goldman Sachs/Amex/Allianz	U.S.A./Germany	Jan. 2006	3,780	10.0
BOC	Royal Bank of Scotland/ Merrill Lynch/ Li Ka Shing Foundation	U.K./U.S.A/ Hong Kong	Aug. 2005	3,048	10.0
	Temasek	Singapore	Sept. 2005	1,524	5.0
	UBS	Switzerland	Sept. 2005	500	1.6
	Asian Development Bank (ADB)	International	Oct. 2005	75	0.2
	Mitsubishi UFJ Financial Group	Japan	June 2006	180	0.2
CCB	Bank of America	U.S.A.	June 2005	2,500	9.1
	Temasek	Singapore	July 2005	1,466	5.1
Joint-stock commercial banks					
BOCOM	HSBC	U.K.	Aug. 2004	1,747	19.9
Shanghai Pudong Development Bank	Citigroup	U.S.A.	Sept. 2003	72	4.6
Mingsheng Bank	Temasek	Singapore	Nov. 2004	106	4.6
	International Finance Corp. (IFC)	International	May 2003	24	1.2
Everbright Bank	ADB	International	Jan. 1997	20	3.0
Industrial Bank	Hang Seng Bank	Hong Kong	Dec. 2003	208	16.0
	GIC	Singapore	Dec. 2003	50	5.0
	IFC	International	Dec. 2003	70	4.0
Huaxia Bank	Deutsche Bank	Germany	Oct. 2005	325	14.0
	Pangaea Capital Management	Singapore	Oct. 2005	125	6.9

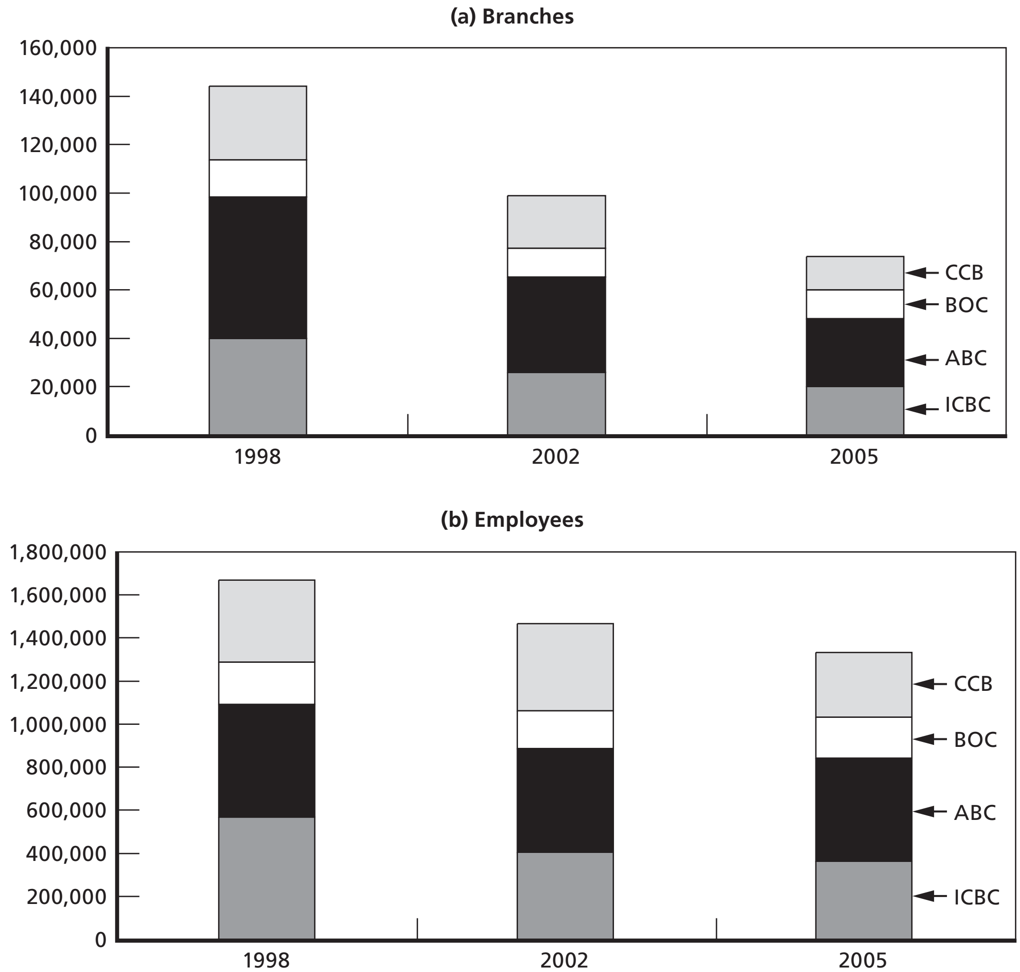
Table 3.9—Continued

Chinese Banks	Foreign Strategic Investors	Nationality	Date of Agreement	Deal Size (US$ million)	Share in Capital (%)
Guangdong Development Bank	Citigroup	U.S.A.	Nov. 2006	723	20.0
Shenzhen Development Bank	Newbridge Capital	U.S.A.	June 2004	149	17.9
	GE Consumer Finance	U.S.A.	Oct. 2005	100	7.0
Bohai Bank	Standard Chartered Bank	U.K.	Sept. 2005	123	19.9
City commercial banks					
Bank of Shanghai	IFC	International	Sept. 1999 Dec. 2001	50	7.0
	Shanghai Commercial Bank	Hong Kong	Dec. 2001	20	3.0
	HSBC	U.K.	Dec. 2001	63	8.0
Bank of Beijing	ING Group NV	Netherlands	Mar. 2005	215	19.9
	IFC	International	Mar. 2005	50	5.0
Tianjin CCB	ANZ Banking Group	Australia	Dec. 2005	120	19.9
Nanjing CCB	IFC	International	Nov. 2001	27	5.0
	BNP Paribas	France	Jan. 2006	87	19.2
Xi'an CCB	Bank of Nova Scotia	Canada	Sept. 2002	7	5.0
	IFC	International	Sept. 2002	20	12.5
Jinan CCB	Commonwealth Bank of Australia	Australia	Nov. 2004	17	11.0
Hangzhou CCB	Commonwealth Bank of Australia	Australia	Apr. 2005	76	19.9
Nanchong CCB	German Investment & Development Bank	Germany	July 2005	5	13.3
Ningbo CCB	OCBC	Singapore	Jan. 2006	71	12.2
Others					
United Rural Cooperative Banks of Hangzhou	Rabobank Group	Netherlands	July 2006	20	10.0
	IFC	International	July 2006	10	5.0

SOURCES: Niikawa (2006), Hope and Hu (2006), Ito (2006).

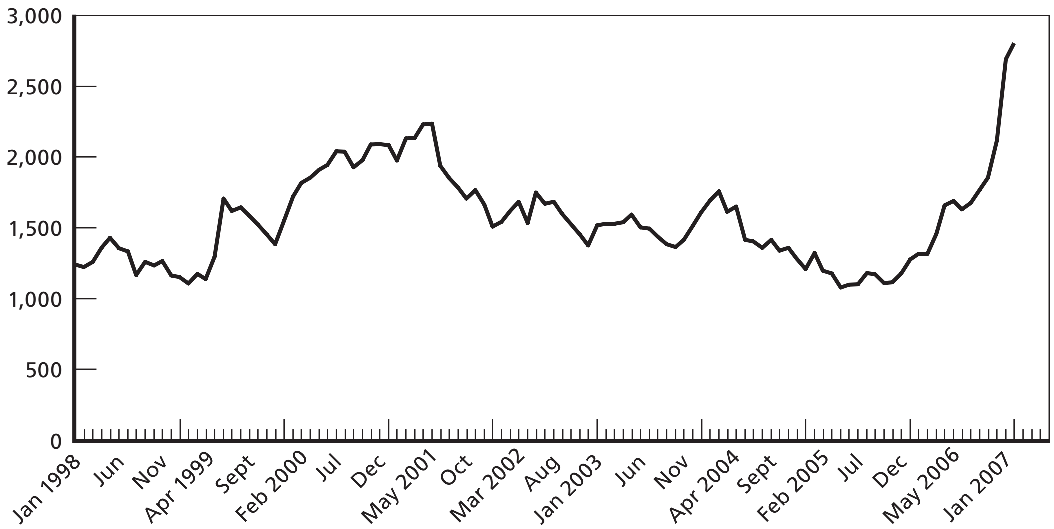
NOTE: The deal size and its share in total capital are as of the date of agreement.

Figure 3.4
Number of Branches and Employees of SOCBs (at end of year)



SOURCES: *Almanac of China's Finance and Banking* for the data for 1998 and 2002, SOCB's annual reports for the data for 2005.
NOTE: The number of employees at the end of 2005 is not comparable across the banks, since the definition of an employee is not unified across the banks' annual reports; for example, CCB includes short-term contract employees, while ICBC only counts medium- and long-term contract employees.
RAND *OP194-3.4*

Figure 3.5
Trend of Shanghai Stock Exchange Composite Index (at end of month)



SOURCE: Shanghai Stock Exchange.
RAND *OP194-3.5*

Table 3.10
Changes in Number of Shares Through IPOs

Bank	Date of IPO	Number of Shares Before IPO (billion)	Type of Share[a]	Number of Shares Issued	Number of Shares After IPO (billion)	Increase in Shares (billion)
ICBC	Oct. 2006	286.5	[H]	40.7	83.1	
			[A]	15.0	251.0	
Totals		286.5		55.7	334.0	47.5
BOC	June 2006	217.9	[H]	29.4	76.0	
	July 2006		[A]	6.5	177.8	
Totals		217.9		35.9	253.8	35.9
CCB	Oct. 2005	194.2	[H]	30.5	224.7	30.5
BOCOM	June 2005	39.1	[H]	6.7	23.1	
	May 2007		[A]	3.2	3.2	
			[N]		22.7	
Totals		39.1		9.9	49.0	9.9

NOTE: The number of shares increased by ICBC's IPO was less than the number of shares issued through the IPO because the government sold a part of their shares to public investors at the IPO in Hong Kong.

[a] [A] denotes A shares denominated in RMB and listed at Shanghai Stock Exchange; [H] denotes H shares denominated in HK dollar and listed on the Hong Kong exchange; [N] denotes non-listed domestic shares (consisting of the shares held by MOF and some SOEs).

Table 3.11
Total Capital Increase by IPOs

Bank	Total Capital (at the end of previous term) (RMB billion) [a]	Type of Share[a]	Selling Price Per Share	Proceeds from IPO Including Issuance Cost (RMB billion) [b]	Share Capital Increased (RMB billion) [c]	Capital Reserve Increased (RMB billion) [d]	Percentage of Total Capital Increase by IPO [e=(c+d)/a]
ICBC	326.2 (June 2006)	[H]	HK$ 3.07	126.6			
		[A]	RMB 3.12	46.6			
Totals				173.3	47.5	97.1	44.3
BOC	233.8 (Dec. 2005)	[H]	HK$ 2.95	90.0			
		[A]	RMB 3.08	20.0			
Total				110.0	35.9	71.1	45.8
CCB	200.9 (June 2005)		HK$2.35	74.6	30.5	42.1	36.1
BOCOM	52.1 (Dec. 2004)	[H]	HK$ 2.50	18.0			
		[A]	RMB 7.90	25.2			
Totals				43.2	9.9	32.3	80.9

SOURCES: Annual report and prospectus for Hong Kong IPOs of each bank.

NOTE: The banks increased their share capital with a book value of one RMB per share. The surplus (deducting issuance cost) was registered as capital reserve.

[a] [A] denotes A shares denominated in RMB and listed at Shanghai Stock Exchange; [H] denotes H shares denominated in HK dollar and listed on the Hong Kong exchange.

Table 3.12
Major Shareholders of the Listed SOCBs

ICBC (at the end of 2006)		BOC (at the end of 2006)		CCB[a] (at the end of 2006)		BOCOM (after the IPO in May 2007)	
Shareholder	Share (%)	Shareholder	Share (%)	Shareholder	Share (%)	Shareholder	Share (%)
Huijin	35.3	Huijin	67.5	Huijin	61.5	MOF	20.4
MOF	35.3	HKSCC Nominees Ltd.[b]	11.9	Jianyin Investment	9.2	HSBC Holdings, plc	18.6
HKSCC Nominees Ltd.[b]	12.9	Royal Bank of Scotland	8.3	Bank of America	8.5	SSF	11.3
Goldman Sachs, Amex, Allianz	7.2	Temasek	4.1	Temasek	6.0	Huijin	6.1

Table 3.12—Continued

ICBC (at the end of 2006)		BOC (at the end of 2006)		CCB[a] (at the end of 2006)		BOCOM (after the IPO in May 2007)	
Shareholder	**Share (%)**	**Shareholder**	**Share (%)**	**Shareholder**	**Share (%)**	**Shareholder**	**Share (%)**
SSF	4.2	SSF	3.3				
		UBS	1.3				
		Asian Development Bank (ADB)	0.2				
		Mitsubishi UFJ Financial Group	0.2				
Breakdown by Type of Shareholder							
State ownership	74.8	State ownership	70.8	State ownership	70.7	State ownership	37.8
Foreign Strategic Investors	7.2	Foreign Strategic Investors	14.1	Foreign Strategic Investors	14.5	Foreign Strategic Investors	18.6
Others[c]	18.0	Others[c]	15.1	Others[c]	14.8	Others[c]	43.6

SOURCES: Annual report and prospectus for IPO of each bank.

[a] Since Huijing directly controls one-third or more of the voting rights in the shareholders meetings in Jianyin, in accordance with the Securities and Futures Ordinance, the interests directly held by Jianyin are deemed indirect interests of Huijing.

[b] HKSCC Nominees Ltd. is a subsidiary of the Hong Kong Securities Clearing Company Ltd., which acts as the common nominee for the shares held in the Central Clearing and Settlement System Depository in Hong Kong.

[c] "Others" includes institutional investors, corporate investors, individual investors, etc.

CHAPTER FOUR

The Current Situation of Major Commercial Banks

As mentioned in Chapter Two, the bank loans are heavily weighted toward funding the nonfinancial sectors in China, and the banking sector is dominated by SOCBs and JSCBs. The government has also been trying to develop capital markets, but many drastic reforms will be required. As to the stock market, urgent tasks include: to diminish the large volume of nontradable shares,[1] to improve the quality of listed companies, and to more widely open the issue market to private companies. The corporate bond market has not developed well, either. The reform of capital markets will take at a minimum another couple of years. So, in the short and medium term, the operational condition of SOCBs and JSCBs will still be critical to sustainable economic development in China.

In December 2006, foreign banks were allowed access to the local currency business through locally incorporated subsidiaries (but not through branches). Twelve foreign banks received approval to begin the preparatory work for establishing local corporations before the end of March 2007, and four of them began a local currency business with Chinese customers in April 2007. This marked the start of a tough competition between Chinese and foreign banks. In this context, concerns about the competitiveness of Chinese banks have become stronger.

Meanwhile, through accounting system reform and public listing, the transparency of major commercial banks has been improved, which makes international comparisons of banks' financial results possible, though there are some reservations regarding the detailed differences in the accounting systems. At first glance, some Chinese banks have become competitive with world-class banks in terms of size of assets and capital. However, as a whole, they are far behind most advanced international banks in terms of the quality of assets and profitability.

[1] The shares in the Chinese stock market are classified as nontradable state shares, legal person shares, employee shares, and tradable public shares. State shares are directly held by government agencies, and legal person shares are owned by enterprises (mainly SOEs), certain institutions, and social groups with legal person status (Liu and Sun, 2005). In 2005, the reform for diminishing nontradable shares (the Split Share Structure Reform) was started. By the end of 2006, more than 95 percent of Chinese listed companies had passed a detailed plan for implementing the reform at their shareholder meetings. Under the government regulation, selling the original nontradable shares should be carried out gradually over three or more years.

Size of Assets

The assets of the four SOCBs (ICBC, ABC, BOC and CCB) are relatively large. At the end of 2006, the ICBC was the third largest in Asia (following two Japanese banks) in terms of size of total assets. Table 4.1 shows the recent development of total assets of major Chinese commercial banks with the world ranking in 2005. The high savings rates and the strict restriction of international capital transactions in China have helped the banks to increase deposits (resources of loan assets). Total capital increase by the government capital injection, IPOs, and the introduction of foreign strategic investors also provided room for the banks to increase lending.

Table 4.1
Total Assets of Major Commercial Banks

	Total Assets at the end of 2006 (US$ billions)	Year on year change (%)	Total Assets at the end of 2005 (US$ billions)	World Ranking
Chinese SOCBs				
Industrial & Commercial Bank of China	961.6	16.3	799.7	21
Agricultural Bank of China	684.4	12.0	591.2	26
Bank of China	682.0	12.3	587.4	27
China Construction Bank	697.7	18.8	568.2	28
Bank of Communications	220.2	20.8	176.4	73
Chinese JSCBs				
China Merchants Bank	119.6	27.2	90.9	114
China CITIC Bank	90.5	18.9	75.8	134
Shanghai Pudong Development Bank	88.3	20.2	71.1	140
China Minsheng Banking Corp.	92.9	30.1	69.0	144
Industrial Bank	79.1	30.1	58.7	164
China Everbright Bank (Dec. 2003)	N/A	N/A	47.7	196
Huaxia Bank	57.0	25.1	44.1	206
Guangdong Development Bank (Dec. 2003)	N/A	N/A	36.5	230
Shenzhen Development Bank	33.4	17.2	28.4	264
World top 5 banks (in 2005) in terms of scale of assets or tier 1 capital				
Barclays Bank	1,956.8	7.8	1,591.5	1
UBS	1,963.9	16.4	1,567.6	2
Mitsubishi UFJ Financial Group (Mar. 2007)	1,591.8	0.1	1,508.5	3

Table 4.1—Continued

	Total Assets at the end of 2006 (US$ billions)	Year on year change (%)	Total Assets at the end of 2005 (US$ billions)	World Ranking
HSBC Holdings	1,712.6	21.7	1,502.0	4
Citigroup	1,884.3	26.1	1,494.0	5
Bank of America Corp	1,459.7	13.0	1,291.8	9
JP Morgan Chase & Co.	1,351.5	12.7	1,198.9	11

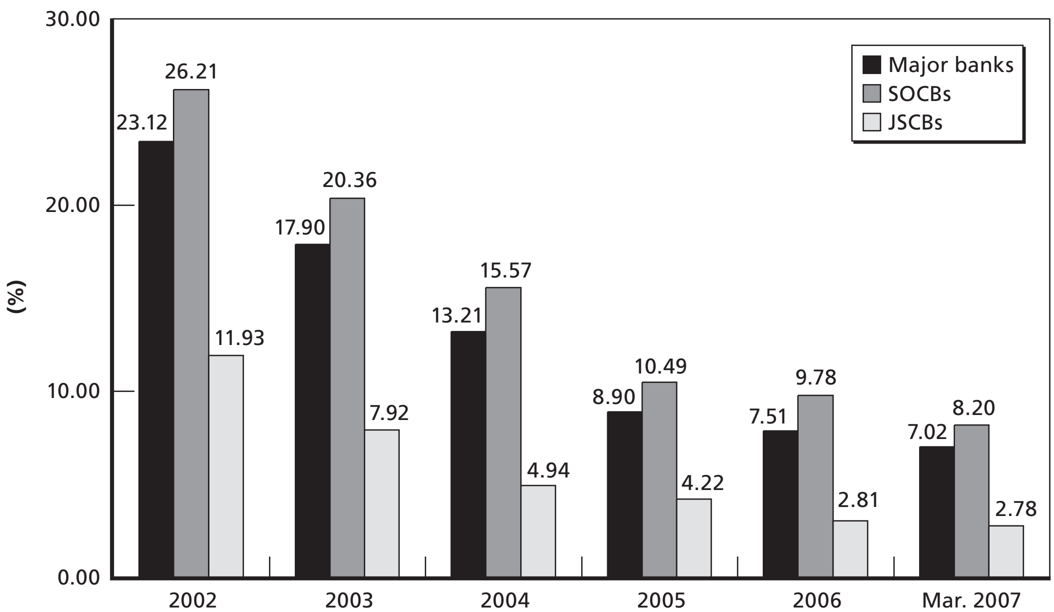
SOURCES: Annual report of each bank (for the 2006 data), and "The Top 1000 World Banks 2006," *The Banker*, July 2006 (for the 2005 data).

NOTE: Year on year change is calculated using local currency.

Quality of Assets

The quality of assets of Chinese banks remains far from ideal. The intensive disposal of NPLs has improved the major commercial banks' NPL ratios greatly (Figure 4.1). The reported aver-

Figure 4.1
NPL Ratios of Major Commercial Banks (at end of year/month)



SOURCE: CBRC.
NOTES: "Major banks" includes 5 SOCBs and 12 JSCBs in 2007. The data for 2007 are not comparable with those for 2006 and earlier because the NPL ratio of the BOCOM is counted in the JSCBs' data until the end of 2006.
RAND *OP194-4.1*

age NPL ratio at the recapitalized SOCBs had declined to 3.28 percent[2] at the end of 2006 from 20.62 percent at the end of 2002. However, comparing top world banks, most of which have NPL ratios below 2 percent, Chinese banks' NPL ratios are still fairly high. There are also large amount of "special mention" loans on the balance sheets of Chinese banks, a category that is not regarded nonperforming but that is defined as "the repayment of loans that might be adversely affected by some factors." In addition, the accuracy of the NPL ratios that Chinese banks report remains controversial; these issues are discussed in further detail in Chapter Five.

Capital Adequacy

The capital adequacy of three SOCBs has seen a fair amount of improvement. Gauged by their amount of tier 1 capital,[3] the recapitalized three SOCBs rank among the world's top 20 banks (see Table 4.2). The CBRC established a regulation requiring commercial banks in China to keep their capital adequacy ratios above 8 percent (in accordance with the Basel Capital Accord) after January 1, 2007. It is reported that more than 66 percent of deposit-taking institutions had cleared this target by the end of 2006. The ABC and some JSCBs are urgently seeking solutions to this difficult challenge. The central government has committed to providing a capital injection to the ABC, but is relecutant to do so for the JSCBs. Since most of the JSCBs' original shareholders are local governments and SOEs, the central government is reluctant to offer a direct bailout. The JSCBs are now looking for new money from local governments and the private sector. It is also hoped that an introduction of foreign funds will help alleviate the situation; however, negotiations to effect such an introduction have not progressed smoothly so far.

Profitability

The profit of the recapitalized SOCBs increased in 2005 and 2006, and indicators of profitability have also improved (see Table 4.3). However, these institutions were supported by various tax exemptions in 2004 and 2005, and their profitability is not strong enough for them to compete directly with foreign banks. According to the author's simple calculations (adopting the same equation that SOCBs use), the average ratio of ROA of the world's seven largest banks (listed in Table 4.1 and Table 4.2) is 1.05 percent, and the average ratio of the top three banks in terms of amounts of tier 1 capital was 1.39 percent in 2005. The profits of Chinese banks largely rely on interest from lending, as their fee businesses are not well developed (see Table 4.4). The profitability of the JSCBs is relatively low despite their rapidly expanding assets.[4]

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[2] ICBC 3.79%, BOC 4.04%, CCB 3.29%, BOCOM 2.01%.

[3] *Tier 1 capital* consists of the types of financial capital that are considered the most reliable and liquid, primarily shareholders' equity. It is regarded as a measurement of strength of banks.

[4] By the author's calculations, the ROA of listed JSCBs in 2005 are 0.57 percent for China Merchants Bank, 0.48 percent for Shanghai Pudong Development Bank, 0.54 percent for China Minsheng Banking Corp., 0.42 percent for Huaxia Bank, and 0.16 percent for Shenzhen Development Bank.

Table 4.2
Amounts of Tier 1 Capital and Capital Adequacy Ratios of Major Commercial Banks

	Amounts of Tier 1 Capital at the End of 2006 (US$ billions)	BIS Capital Adequacy Ratio at the End of 2006 (%)	Amounts of Tier 1 Capital at the End of 2005 (US$ billions)	World Ranking in 2005
Chinese SOCBs				
Industrial & Commercial Bank of China	59.4	14.05	31.7	16
Agricultural Bank of China	11.4	N/A	9.9	60
Bank of China	52.5	13.59	31.3	17
China Construction Bank	39.6	12.11	35.6	11
Bank of Communications	9.0	10.83	8.9	65
Chinese JSCBs				
China Merchants Bank	6.8	11.40	2.9	173
China CITIC Bank	4.0	9.41	2.6	188
Shanghai Pudong Development Bank	3.0	9.27	1.8	251
China Minsheng Banking Corp.	2.4	8.12	1.9	247
Industrial Bank	2.0	8.71	1.5	297
China Everbright Bank (Dec. 2003)	N/A	N/A	1.4	311
Huaxia Bank	1.4	8.28	1.2	339
Guangdong Development Bank (Dec. 2003)	N/A	N/A	0.7	495
Shenzhen Developmet Bank	0.8	3.71	0.6	548
World top 5 banks in terms of scale of assets or tier 1 capital (in 2005)				
Barclays Bank	45.2	11.7	32.5	14
UBS	33.2	14.7	30.4	18
Mitsubishi UFJ Financial Group (Mar. 2007)	68.5	12.6	63.9	5
HSBC Holdings	87.8	13.5	74.4	2
Citigroup	90.9	11.7	79.4	1
Bank of America Corp	91.1	11.9	74.0	3
JP Morgan Chase & Co.	81.1	12.3	72.5	4

SOURCES: Annual report of each bank (for the 2006 data, except that the data of the Agricultural Bank of China are from *The Banker*, June 2007), and "The Top 1000 World Banks 2006," *The Banker*, July 2006 (for the 2005 data).

It should be noted that as of late the staff costs of SOCBs are not decreasing but increasing, even after reducing large number of branches and employees (see Table 4.5). BOC explains that the implementation of the new salary system, which assigned salary levels based on a consistent assessment of roles, responsibilities, and market competition levels, increased the staff costs to a large extent. In addition, since most of banks are expecting larger investment in their network infrastructure and technology, reducing costs will not be so easy.

Table 4.3
Profit and Indicators for Profitability of SOCBs

Institution	Year	Pre-Tax Profit (RMB million)	Year-on-Year Change (%)	ROA (%)[a]	ROE (%)[b]	Cost-to-Income Ratio (%)[c]
ICBC	2005	62,876	15.8	0.66	13.30	37.75
	2006	71,521	13.7	0.71	N/A	36.04
ABC	2005	7,878	-6.7	0.02	N/A	66.15
	2006	12,187	54.7	0.11	N/A	50.44
BOC	2005	55,140	59.5	0.72	13.16	39.30
	2006	67,009	21.5	0.94	13.86	38.96
CCB	2005	55,364	8.1	1.11	21.59	45.13
	2006	65,717	18.7	0.92	15.00	43.97
BOCOM	2005	12,843	65.7	0.72	13.68	51.24
	2006	17,405	35.5	0.78	14.15	47.66

SOURCES: Annual report of each bank, except that the ROA data for ABC are based on the author's calculations.

[a] ROA = after-tax profit/average total assets

[b] ROE = after-tax profit/average owner's equity

[c] Cost-to-income ratio = general and administrative expenses/total operating income

Table 4.4
Share of Net Interest Profit and Net Fee and Commission Profit to Net Operating Profit (2005)

Institution	Net Interest Profit (%)	Net Fee and Commission Profit (%)
ICBC	91.1	6.5
BOC	86.5	8.0
CCB	90.6	6.6
BOCOM	89.9	6.0

SOURCES: Annual report of each bank.

NOTE: Net operating profit is before deduction of administrative cost.

Table 4.5
Year-on-Year Changes in Staff Costs of SOCBs

Institution	2004 (%)	2005 (%)	2006 (%)
ICBC	10.1	26.0	24.2
BOC	20.9	21.0	27.9
CCB	-4.5	23.1	18.3
BOCOM	21.7	23.9	28.0

SOURCES: Annual report of each bank and prospectus for IPO.

CHAPTER FIVE

Issues and Challenges in the Further Development of the Chinese Banking System

Although the Chinese commercial banks' condition has improved in recent years, critical questions regarding their further development remain. The Chinese government held the Third National Financial Work Conference in January 2007 to review the achievements of their policies over the last five years and to discuss reform targets for the next few years. Much like the previous conferences, this one did not produce a detailed decision on every specific issue. In a keynote speech at the conference, Premier Wen Jiabao emphasized six areas that required intensive efforts: deepening the reform of SOCBs, facilitating rural financial reforms, developing the capital and insurance markets, improving the ability of financial services and functions to adapt to economic development, opening financial business actively and modestly to foreign entities, and strengthening supervision of financial institutions.[1]

In the area of banking-system reform, policy banks are now required to transform their business structures. The roles and functions of the AMCs were reviewed on the premise that the NPL problem has not been resolved and that doing so will require more market-oriented mechanisms. Newspapers also reported that Huijin would move its business focus from bailing out banks to leading banks to improve corporate governance and to the efficient management of foreign exchange reserves.

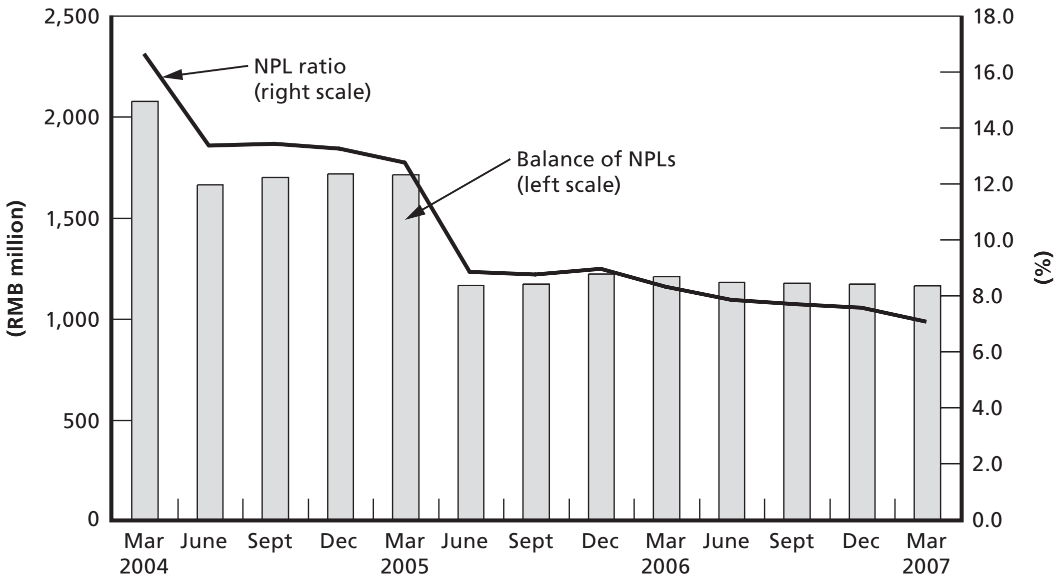
A Large Volume of NPLs

Because of the large amount of remaining NPLs, the stability of Chinese commercial banks remains in question. As mentioned in Chapter Four, the NPL ratios of Chinese commercial banks are still high, and the amount of NPLs has not always decreased smoothly (see Figure 5.1).

The burden presented by the NPL problem is extensive, both to the commercial banks and to the government. After receiving a great amount of support from the government, most commercial banks now have to dispose NPLs out of their own provisions or profit. The low profitability of the banks might be an obstacle for the intensive disposal of NPLs. In addition, unless commercial banks can resolve the NPL problem, they will have to remain very wary of

[1] State Council, Secretary's Office, 2007.

Figure 5.1
Amount of NPLs and NPL Ratio at Major Commercial Banks



SOURCE: CBRC.
NOTES: The major commercial banks include 5 SOCBs and 12 JSCBs.
RAND *OP194-5.1*

the risks presented by providing new loans to the private sector or to new customers, especially small- and medium-sized enterprises. This may lead to an irrational allocation of funds.

Moreover, there are some estimates that NPLs in China may begin to increase. The Fitch Ratings estimated that the deposit-taking institutions had US$ 271 billion of possible NPLs, which were basically classified as "special mention," a gray area between "normal" and nonperforming loans, at the end of the first quarter of 2006. Officially, the total amount of NPLs was US$ 206 billion (US$ 164 billion in commercial banks accounts and US$ 42 billion in those of noncommercial banks) (see Table 5.1).[2] The "special mention" loans tend to deteriorate easily if economic conditions become unfavorable.

Many commercial bankers outside China believe that no bank can expand its assets as quickly as Chinese banks have in recent years without incurring a large number of loans that will become impaired at some point in the future. UBS Securities Asia, Ltd., estimated Chinese commercial banks might have new NPLs as high as US$ 225 billion, related to the loans that they had offered during the overheating period of 2002 to 2004.[3] The recent rapid increase in property loans has also received a lot of attention from the Chinese government.

Furthermore, large amounts of NPLs remain on the balance sheets of the AMCs. As explained in the Chapter Three, the four AMCs purchased US$ 330 billion NPLs (nominal value) from four SOCBs and BOCOM, and it will purchase an additional large amount of

[2] Fitch Ratings, 2006.

[3] Anderson, 2006.

Table 5.1
Estimated NPLs in the Chinese Banking System

	Official NPLs (US$ billion)	Other Estimated NPLs (US$ billion)
Commercial banks (March 2006)	164.0	160.0
4 SOCBs	132.0	105.0
12 JSCBs	18.0	37.0
Noncommercial banks	42.0	111.0
Rural credit cooperatives (end 2005)	40.0	40.0
Policy banks (end 2004)	2.0	66.0
AMCs	197.0	N/A

SOURCE: Fitch Ratings (2006).

NOTE: In this table, BOCOM is defined as JSCB (not an SOCB), and the data for Bohai Bank are not included.

NPLs from the ABC in the near future. The AMCs also have some NPLs that were transferred to them from the State Development Bank. In addition, the Chinese government permitted the establishment of another state-run AMC, Huida Asset Management Ltd. Company (Huida AMC), in August 2005. It was based on the Everbright Asset Management Company, which was headquartered in Guangzhou. The reorganized Huida AMC is owned by Cinda AMC, but there is little official information regarding details of the organization. Chinese media reported that Huida AMC would handle NPLs left over by the PBC in Guangdong, Hainan, and Guangxi Beihai districts, mainly from the 1990s.[4] The value of the central bank's NPLs was not disclosed. It was also unclear what kind of NPLs would be transferred to Huida AMC.[5]

No information on the management condition of AMCs was disclosed. The CBRC discloses the progress of four of the AMCs' NPL disposal efforts quarterly. However, this data only includes NPLs that were transferred before 2002 and doesn't cover the condition of NPLs transferred after 2004. No AMC discloses the losses they have incurred through the disposal of NPLs, nor do any of the AMCs disclose how such losses have been made up by the government. It is estimated that about US$ 200 billion worth of NPLs are still on the books of the AMCs (excluding Huida).[6]

The sustainability of the national budget must also be considered within the context of this issue. Abundant foreign exchange reserves and relatively modest government debt[7] may allow the government to handle the problem in the short term. It should be noted, however,

[4] "China Sets Up New Firm to Handle Bad Loans by Central Bank," 2005; and "Yanghang Guanjia, Huida Dengchang," 2006.

[5] "Stop Issuing Fresh Bad Loans," 2005.

[6] Fitch Ratings, 2006, and Bottelier, 2006b.

[7] The China's foreign exchange reserves were US$ 1,073 billion at the end 2006, and the fiscal deficit of the central government in 2005 was RMB 300 billion, 1.6 percent of the GDP for that year. The *People's Daily* reported that outstanding

that government debt may swell if the government mismanages social security and the economic growth of the country's least-developed regions. Furthermore, the foreign exchange reserves should be used cautiously to prepare for a possible future deficit in the country's international balance of payments.

The four AMCs were originally designed to be closed within 10 years, but they are now expected to continue under a more market-oriented business style. It is reported that they are trying to transform their organizations into commercial entities resembling investment banks. In February 2007, Huarong, Dongfang, and Cinda AMCs received approval to establish security companies. Huarong AMC and Cinda AMC also established joint-venture asset-management companies with foreign banks. The joint-venture AMCs are expected to develop a commercial business around NPLs and introduce market-oriented mechanisms into the NPL secondary market.

The reliability of official reports regarding NPLs is another question. Though the Chinese government has tried to obtain accurate numbers and the managers of commercial banks understand the importance of this effort, it will not be easy for commercial banks to establish an accurate and comprehensive loan classification system in a short period of time. The five-category loan classification system ultimately depends on subjective judgments, and there is much room for inaccurate reporting.[8] In addition, the standard by which loans are classified may not yet be thoroughly applied among the huge number of branches of the SOCBs.[9] Furthermore, if (as is common) borrowers don't submit factual data as to their financial condition, commercial banks have a difficult time gauging the risk of extending loans to these customers.

Implementation of Basel II

A new international supervisory framework for capital adequacy requires Chinese commercial banks to introduce improved risk-management practices. The Basel Committee on Banking Supervision issued the International Convergence of Capital Measurement and Capital Standards: a Revised Framework (Basel II) in 2004, which was expected to be implemented in member countries' jurisdictions (central banks and/or bank supervisory authorities of the G10 countries)[10] as of the end of 2006. The framework for Basel II is built on the 1988 accord's basic structure for setting capital requirements to promote the adequate capitalization of banks and to encourage improvements in risk management, thereby strengthening the stability of the financial system. These goals are expected to be accomplished through the introduction

government bonds at the end of 2004 totaled RMB 2.96 trillion, about 22 percent of GDP, much less than the 60 percent internationally regarded as a risky level. ("Zhongguo Guozhai Yu'e 29631 Yi Yuan," 2005)

[8] "Shuangjiang Neng Wei Shangye Yinhang Jianghuo Ma?" 2005.

[9] According to the banks' annual reports, the numbers of branches at the end of 2005 are ICBC–18,864; ABC–28,234; BOC–11,646; and CCB–13,983.

[10] Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

Table 5.2
Three Pillars for the Implementation of Basel II

	Pillar 1	Pillar 2	Pillar3
Focus	Aligning the minimum capital requirements more closely to each bank's actual risk of economic loss	Recognizing the necessity of exercising effective supervisory review of banks' internal assessments of their overall risks	Leveraging the ability of market discipline to motivate prudent management by enhancing the degree of transparency in banks' public reporting
Method	Credit risk assesment: Basel II improves the capital framework's sensitivity to the risk of credit losses generally by requiring a higher level of capital for those borrowers thought to present higher levels of credit risk, and vice versa. Operational risk assessment: Basel II establishes an explicit capital charge for a bank's exposures to the risk of losses caused by failures in systems, processes, or staff or those caused by external events, such as natural disasters. Market risk assessment: Basically the same as the framework of 1988 Accord	Supervisors will evaluate the activities and risk profiles of individual banks to determine whether those organizations should hold higher levels of capital than the minimum requirements in Pillar 1 would specify and to see whether there is any need for remedial actions. The Basel Committee expects that, when supervisors engage banks in a dialogue about their internal processes for measuring and managing their risks, they will help to create implicit incentives for organizations to develop sound control structures and to improve these processes.	The Basel Committee believes that, when marketplace participants have a sufficient understanding of a bank's activities and the controls it has in place to manage its exposures, they are better able to distinguish between banking organizations so that they can reward those that manage their risks prudently and penalize those that do not.

SOURCES: BIS, Financial Services Agency of Japan, Bank of Japan.

of "three pillars," namely: the minimum capital requirement, supervisory review, and market discipline (see Table 5.2).[11]

Basel II is to be implemented in member countries first and is expected to be widely adopted in other countries as time passes, much as the 1988 accord was applied initially only to internationally active banks in the G10 countries but soon became a benchmark measure of any bank's solvency. The 1998 accord has been adopted in some form by more than 100 countries. In 2006, the CBRC announced that Chinese large commercial banks having overseas operational entities were required to implement Basel II by the end of 2010, with a three-year grace period. It also encouraged small- and medium-sized commercial banks to implement the new accord on a volunteer basis.[12]

CBRC Chairman Liu Mingkang expressed that the provisions of Basel II could promote rational and effective bank management, ensure that adequate provisions for loans and regulatory capital are in place, and boost the transformation of the profit-making models and the patterns of business growth. Under the new accord, the provision for NPLs is much stricter than before. The major Chinese commercial banks are required to assess the adequacy of their capital and to establish internal processes for measuring and managing risks. Uncovered NPLs

[11] BIS, 2004.

[12] CBRC, 2006.

are to be reflected more negatively in assessments of risk assets and will require much more capital than under the previous accord.

The current tax system is not very favorable to accurate provision. The strictly limited pre-tax write-back of provisions for lost loans restrains banks' willingness to increase provisions. While there are some exceptional conditions under which loans may be written back before tax, many of the local tax authorities are reluctant to allow such special treatment.[13]

Inefficient Allocation of Fund Resources

A more serious issue in the Chinese banking system is the inefficiency of fund allocations by commercial banks. One analysis indicates that for each US$ 1.00 of GDP growth since 2001 China has required US$ 4.90 of new investment, which is nearly 40 percent more than the investment required in South Korea and Japan during their high-growth periods. China required US$ 3.30 in the first half of the 1990s.[14] While this inefficiency has multiple causes, the banks are certainly one important cause. As of mid-2006, less than one percent of all loans extended by SOCBs were going to private businesses employing over 200 million people and accounting for about 50 percent of the country's GDP[15]. The private sector has largely relied on informal finance (*minjian jinrong* [private finance] or *dixia jinrong* [underground finance]). This situation is caused not only by the banking system but is also due to the undeveloped capital market. Even so, efficiency would be improved greatly if banks would provide loans to more productive private enterprises, or if they could provide loans with reasonable interest rates based on accurate risk assessments.

The government encourages banks to lend money to profitable private enterprises and the PBC relaxed the commercial banks' lending rate ceiling in October 2004 to provide a favorable environment under which commercial banks could take some risks by charging higher interest rates; however, loan pricing by SOCBs is not very differentiated yet. Slow implementation of changes in sizable SOCBs' operations, low priority for interest rate differentiation in an environment of abundant liquidity, and a decision by banks not to charge higher interest when that would worsen clients' conditions are the main reasons for this trend.[16]

At the Third National Financial Conference, Premier Wen indicated that policy banks should also be reformed. The State Development Bank was to be transformed into a more commercially oriented bank focused mainly on medium- and long-term lending. As to policy lending, the government planned to introduce auction systems to improve transparency. This would also serve as an effective means of increasing the efficiency of fund allocation.

More importantly, the lack of reliable corporate credit information makes it difficult for commercial banks to assess the risk of lending. In order to supplement corporate and individ-

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[13] Xie et al., 2006.

[14] Farrell and Lund, 2006.

[15] Tsai, 2006.

[16] Podpiera, 2006.

ual credit data, the PBC created a credit registry system. The PBC began to compile corporate credit information in 1997 and began to operate a regional (city) database in early 2002 and a nationwide database in 2005. Since 2004, the PBC has been developing a credit information database for individuals. Almost every commercial bank now submits inquiries to this system as a part of any pre-lending assessment.[17]

Since Chinese commercial banks do not have enough historical or empirical data on the probability of contract breach and loss, it will take a long time for them to establish a reliable formula for risk pricing. Foreign strategic investors are expected to make a contribution in this area. Some banks have established risk management committees under the executive board and have invited foreign specialists to serve as members of these boards and advise banks on risk control matters.

As to the finance for private sector, the government authorities are making effort to limit informal finance by increasing private sector access to the banking system and experimenting with regulation of certain informal financial institutions. The conversion of urban credit cooperatives into city commercial banks starting in 1997 was meant to not only improve the efficiency of credit cooperatives but also to provide financial services to credit-worthy private businesses.[18]

Rural financial system reform, including establishing China Postal Savings Bank, is also critical to develop financial service networks in rural areas where about 750 million people live. The Agricultural Bank of China (an SOCB), the Agricultural Development Bank of China (a policy bank), and rural credit cooperatives are required to promote restructuring in order to provide better service in rural areas.

Enhancement of Corporate Governance

Enhancing corporate governance is a priority task for commercial banks. The aforementioned problems would be largely ameliorated if the commercial banks could improve their corporate governance. The CBRC issued several guidelines designed to enhance corporate governance. The Guidelines on Corporate Governance of State-Owned Commercial Banks and the Guidelines on Internal Audit of Banking Institutions are the newest rules regarding the internal management of financial institutions in China. These guidelines require banks to establish several special committees under the board of directors: a strategic development committee, an audit committee, a risk policy committee, a personnel and remuneration committee, and a connected transaction control committee. Most of the major commercial banks invite foreign bankers to serve on their boards or as special committee members.

The role of the Communist Party Committee in corporate governance is an important facet of the reform efforts. In China, the Communist Party Committee in each SOCB has retained critical power over the bank's decisionmaking process; in the past, when a conflict between banks' creditworthiness goals and the CPC's goals (such as increasing employment

[17] Su Ning, 2006.

[18] Tsai, 2006.

and maintaining social stability) arose, the Party's goals tended to come first. New shareholders, foreign strategic investors, and general investors joining the shareholder community via public listings are expected to increase the demand that banks' decisions be based on commercial concerns. However, the impact of these changes is limited since the new shareholders are still minority.

The function of Huijin is also under review. In 2005, Huijin provided three security companies with local currency capital (see Table 5.3); these actions were regarded as a kind of bailout. At first, the Huijin seemed to be an emergency fund provider backed by a large amount of the country's foreign exchange reserves. Huijin was also expected to lead the structural reform of recapitalized financial institutions. However, questions have arisen regarding the decision-making process within Huijin. Some members of the NPC insist that Huijin should be supervised by the NPC when it is making a decision to move important national assets. In March 2007, Chinese government explained that they were planning to establish a governmental investment agency to manage country's increasing foreign exchange reserves. It is not yet clear whether Huijin will be merged into a new organization.

Table 5.3
Investments into Financial Institutions by Huijin

Date of Investment	Financial Institution Invested	Amount of Investment
Dec. 2003	BOC	US$ 22.5 billion
Dec. 2003	CCB	US$ 20.0 billion
Dec. 2003	Jianyin Investment	US$ 2.5 billion
June 2004	BOCOM	RMB 3.0 billion
Apr. 2005	ICBC	US$ 15.0 billion
June 2005	Galaxy Security	RMB 10.0 billion
July 2005	Export and Import Bank of China	US$ 5.0 billion
Aug. 2005	Shenying Wanguo Security	RMB 2.5 billion
Aug. 2005	Guotai Junan Security	RMB 1.0 billion
Aug. 2005	Galaxy Holdings	RMB 5.5 billion
Sept. 2005	Everbright Bank	RMB 10.0 billion

SOURCE: Cheng (2006).

NOTE: The investment in Everbright Bank has not been confirmed. There are some reports that Huijin has not invested in the bank but is prepared to invest approximately RMB 20 billion in the near future.

Establishment of Laws and Regulations

Since the 1990s, the legal environment in China has improved remarkably, especially as China has made changes to the legal system in accordance with the country's accession to the WTO. However, it is also obvious that improvements have not kept up pace with the rapidly changing economic environment. Regarding the banking sector, a senior executive of the PBC has pointed out many urgent issues, such as the lack of regulations on credit registry, the underdeveloped enterprises insolvency law, the weakness in criminal liability investigation for financial frauds and irregularities, and the lack of laws governing financial institutions and business.[19] The PBC also launched a joint study project on secured transactions reform with the World Bank and the IFC, the main tasks of which were to investigate and analyze the extent to which movable assets were being used as collateral and to propose a series of reforms that would establish a new framework.[20]

The Provisional Enterprise Bankruptcy Law issued in 1986 only covered SOEs, and there was no guarantee for lenders when private companies in which they had invested faced bankruptcy. The law was amended and reissued as the Enterprise Bankruptcy Law in August 2006, the enforcement of which was to begin in June 2007. The new law provides a unified bankruptcy system for all enterprises, covers both SOEs and privately-owned companies (including foreign invested enterprises), and is expected to bring China's enterprise bankruptcy system closer to international standards.[21]

The PBC had submitted several proposals to amend the Security Law of 1995 to extend the usage of collateral and also recommended the establishment of a law governing the registration of property.[22] A new Property Law that includes provisions on security and mortgage passed the NPC in March 2007 (to be enforced in October 2007). The law provides wider usage of collateral than the Security Law, and the rules in the law take precedence over ones in the Security Law when they are inconsistent with each other. Detailed regulations will be issued in near future.

Currently, when banks try to enforce their rights to collateral, they face a number of difficulties: the property registration system is not complete, most cases require intervention by the courts because of a lack of motivation for reconciliation on the part of counterparties, the length that claims for collateral can be tied up in the courts is relatively long, and the court expenses and legal fees that banks incur when executing collateral claims are high.[23] Banks often face difficulty enforcing court decisions due to local government intervention.

[19] Xiang, 2005.

[20] Su Lin Han, 2006.

[21] Morrison & Foerster LLP, 2006.

[22] Tang and Liu, 2006.

[23] He, 2006.

Fraud and Corruption

The problems of fraud and corruption are impediments to the further development of market mechanisms in China. Recently, there have been a number of reports of fraud and corruption in China's banking sector. It is not necessarily clear whether financial crimes are on the increase or whether more crimes are being reported and uncovered with improved disclosure practices. However, it is clear that there are three new financial-crime trends emerging in China: high-tech financial crimes; the use of illegally obtained funds to bribe officials in order to escape punishment and to avoid regulation, and financial crimes with a more sophisticated, global focus.[24]

The Chinese government is strengthening institutional mechanisms for exposing and eradicating financial crime and corruption. Commercial banks are also making efforts to thwart crime in cooperation with the CBRC. In July 2006, 68 members of the China Banking Association signed an anti-bribery commitment and three conventions pledging to strengthen self-discipline, promote fair competition, resist illegal transactions, and establish a system to combat commercial bribery. The members agreed to cooperate on these issues with a special working program run by the CBRC.

The Deregulation of Financial Markets

The sequence of financial-market deregulation is critical both to the government and to commercial banks. In China, interbank interest rates are basically liberalized, but bank deposit and lending rates that affect enterprises and individuals directly are still restricted by the PBC. Although the PBC abolished the ceiling on lending rates and the floor on deposit rates in 2004, it retains the floor on lending rates and the ceiling on deposit rates. This restriction is intended to protect fragile deposit-taking institutions. The abolition of restrictions on interest rates might cause severe competition among financial institutions, causing extensive damage to weak deposit-taking institutions. Even stronger banks might offer unreasonably low lending rates just in order to keep their market shares until they are seriously exhausted. The PBC seems to be taking a cautious approach to the timing of further deregulation.

The foreign-exchange-rate mechanism also needs to be reformed. The PBC abolished the de facto U.S. dollar–pegged exchange rate system in July 2005; however the RMB exchange rate has appreciated only less than 9 percent since then until June 2007 (see Figure 5.2). The Chinese government explains that one of the main reasons for this is the fragility of parts of the domestic economy. It seems to be worried about fragile sectors such as agriculture, textile manufacturing, and other labor-intensive and low-technology manufacturing sectors. It might also want to restrain the impact on the value of the foreign assets of major domestic financial institutions before those institutions complete their structural reform.

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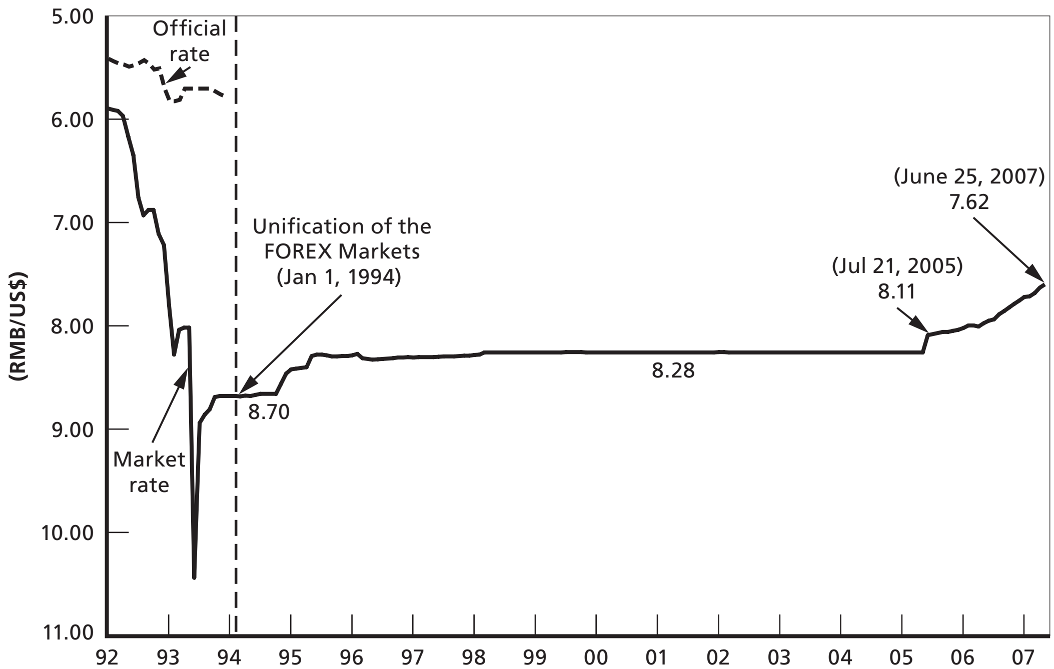
[24] Luo, 2006.

Figure 5.2
Movement of RMB Exchange Rate to U.S. Dollars



SOURCE: SAFE.
RAND *OP194-5.2*

The slow pace of the reform of the foreign-exchange-rate system is diluting the effectiveness of the central bank's monetary policy, which in turn affects China's macro-economic control mechanism. In order to ensure that commercial banks can adapt to a more-flexible, floating foreign-exchange-rate system, the PBC and SAFE are making an effort to develop a foreign exchange market by establishing swap and future markets, introducing the market-maker system, and increasing the number of participants in the interbank foreign exchange market. The Chinese government, as a whole, prefers gradual reform in this area. However, it faces tremendous pressure created by China's huge trade surplus and increasing capital inflow.

Competition with Foreign Banks

The question as to Chinese commercial banks' ability to compete with foreign banks must be posed in the context of three arenas: in the current domestic financial markets, in the more open and developed domestic markets of the future, and in global markets.

First, in the short run, it is not easy for foreign banks to enter into the Chinese market. Banks that apply for entry into the local currency business are required to incorporate a subsidiary in China and to keep the BIS capital-adequacy ratio for each subsidiary. This costs far more than simply opening branches. In addition, as long as Chinese financial markets are not fully developed and international capital transactions are firmly restricted, foreign banks may

face difficulty securing funding. The domestic banks' deposit-taking ability is much higher than that of foreign banks, mainly because they have large branch networks and the people have a tacit understanding that deposits in domestic major banks will be secured by the government in the event of a crisis. Furthermore, foreign banks are restrained from offering high levels of services using such skills as derivatives management because of China's restrictions on capital transactions and its incomplete legal system.

At the end of 2004, when foreign banks were not allowed to operate local currency business with individuals, foreign banks' share of the deposit market and lending markets in China was very small: 1 percent of the deposit market and 2 percent of the lending market. These percentages would not expand rapidly in the short term. However, the Chinese government is concerned that because only 20 percent of domestic depositors are responsible for 80 percent of total deposits in the country, a small movement of those richest depositors from domestic banks to foreign banks might cause extensive damage to the domestic banks.[25]

The long-term picture is different. As long as Chinese enterprises continue to globalize and the wealth of the Chinese people continues to increase, China will need increasingly advanced financial services. The government will mostly likely ease restrictions on international capital transactions gradually; as they do so, advanced foreign banks will gain opportunities to offer more sophisticated services in China. Most recently, the government is further opening the domestic market to foreign and domestic private equity investment groups, which will provide enterprises with a certain amount of money without going through commercial banks.

The introduction of foreign strategic investors is one of the preparations for developing new financial services. The Chinese government expects foreign banks to cooperate in developing credit card business, investment banking, retail banking, e-commerce, etc. By opening Chinese financial markets the government is endeavoring to create a "win-win" situation; to do so they must provide more opportunities not only for Chinese banks but also for foreign banks.

When the government abolished regional and customer restrictions on foreign banks in December 2006 in accordance with its WTO commitments, the CBRC promulgated the Guidelines on Financial Innovation of Commercial Banks. These guidelines encourage innovation among commercial banks and promote the development of new banking products and services. CBRC officials explained that China's banking industry urgently needs to speed up the pace of financial reform in order to confront the competition that is sure to arise once markets are fully opened. Currently, Chinese commercial banks lag far behind their international counterparts in terms of financial innovation.[26]

In order to compete with global financial conglomerates, the government is considering the establishment of financial holding companies that would provide comprehensive banking, securities, and insurance services. The trial has already started in the CITIC Group, the Everbright Group, and the Ping An Insurance Group. It is also reported that the CCB and

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[25] Wang Zhaoxing, 2006.

[26] Lu, 2006.

BOCOM have applied for permission to establish insurance companies.[27] However, the regulatory system requires further reform that makes it easier for such institutions to diversify.

Merger and Closure of Fragile Deposit-Taking Institutions

Standing in contrast to the recovery of most major Chinese commercial banks, quite a few small banks and credit cooperatives face continued severe financial difficulties. The Chinese government paid a great deal of attention to the reform of rural credit cooperatives (RCCs). The PBC provided financial support to help the RCCs to dispose of NPLs and encourages them to merge into larger, more stable organizations. Smaller urban commercial banks have also undertaken significant reorganization efforts. However, the further restructuring of small financial institutions is a prerequisite for establishing a sustainable and efficient financial system.

In order to protect depositors, a deposit insurance system is required. The National Congress and the CPC have reviewed a draft deposit insurance law that was prepared by the PBC. The government wants to create a deposit insurance system while the domestic economy is in good shape and while the financial system is not threatened with serious disorder.[28]

Information Sharing

Information sharing among all participants is crucial in maintaining the stability of the financial system. The government authorities need prompt, accurate, and comprehensive data in order to effectively monitor and supervise the system. Although progress has been favorable in the availability of monetary data, banking statistics, balance-of-payments statistics, and international investment positions, serious shortcomings in accuracy and coverage remain. As mentioned in previous chapters, the accuracy of NPLs and banks' accounts should be improved further, and more training of experts is needed.

The disclosure of information on the financial activities of banks and enterprises to investors and to the general public is a prerequisite for the gaining of confidence in the financial system. In order to prevent groundless rumors from stirring anxiety among investors and the public at large, accurate market-related information should be announced as early as possible. Fair access to information sources should also be improved.

The PBC is also promoting "financial education." In February 2007, it issued the *Financial Knowledge Booklet*, which has three parts: basic financial theories and concepts, the operation of and risks involved with various financial services and products, and the central bank. This publication is intended to deepen the general public's understanding of finance. A PBC senior official noted that the booklet used concise and simple language and illustrations, as well

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[27] Lu, 2006.

[28] Wei, 2007.

as household stories and cases, to explain financial terminologies and concepts and complex economic and financial phenomena.[29]

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[29] Su Ning, 2007.

CHAPTER SIX

Conclusion

In China, the reform of the financial system has been carried out cautiously and gradually; however, much progress has been made to date, particular considering the fact that banking-system reform based on market mechanisms began less than 15 years ago. In particular, the structural reform of major Chinese commercial banks progressed significantly in the four years following 2002. Efforts by the government and by commercial banks are beginning to bear fruit. They have reduced balance sheet problems and improved performance. With major commercial banks in better shape and in light of the remaining restrictions on international capital transactions, fear of losses due to the competition with foreign banks is not a serious issue, at least in the short term.

However, this is just the beginning. Along with the globalization of the Chinese economy, it is inevitable that the financial system has become more open and market oriented. In addition, competition will become more severe even among domestic financial institutions, and that might threaten financial stability, especially in rural areas, if the supervisory authorities fail to keep the confidence of general public. There are many important steps in establishing a well-functioning financial system that serves the entire country.

At present, the first priority of Chinese banks is to continue to improve their balance sheets. Considering the questionable reliability of existing data, the recent rapid increase of lending, and the remaining huge NPLs held by AMCs, it is still difficult to judge whether the NPL problem in China has actually turned the critical corner toward substantial resolution. Small financial institutions in rural area and smaller cities also must clean up their balance sheets and prepare to compete with larger banks.

Enhancing the corporate governance of commercial banks is a more-important, longer-range task. This requires an essential change in the role of the CPC and the government in these institutions, not only at the central level but also, and more importantly, at the local level. Public listings and the introduction of foreign strategic investors should help to press this issue. However, if the central and local government officials as well as Party leaders do not truly understand the importance of corporate governance, banks might never change, since new investors only hold minority shares.

Establishing a reliable credit culture is another prerequisite for a market-oriented economy. Rather than interfering directly in individual corporate activities, the government needs to enact new laws and regulations, implement them fairly and strictly, and review their efficacy regularly. Accounting system reform, both in banks and in commercial enterprises, should be

enacted along international standards. The suppression of corruption and fraud is also crucial to establishing a trustworthy credit system.

Adopting reforms in a proper sequence will help to absorb shocks that threaten social stability. Since there have been few precedents for such sweeping changes in a country with such large population and territory, China will continue to carry out experimental measures cautiously. However, the government must strive to distinguish between reasonable protective measures and overprotection, a feat that has proven difficult for other countries. Strong leadership and the sharing of information to gain national understanding will be necessary for success.

Chinese banks have moved decisively into the market economy. They have addressed their most serious weaknesses. They have learned from foreigners and are prepared to deal with foreign competitors. Chinese government regulations have become far more sophisticated. But important bank vulnerabilities remain, and China's financial system is still far from being able to accomplish its central task: allocating credit in an efficient way to all sectors.

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